BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks.	R.93-04-003
Investigation on the Commission's Own Motion into Open Access and Network Architecture Development of Dominant Carrier Networks.	I.93-04-002
Order Instituting Rulemaking on the Commission's Own Motion Into Competition for Local Exchange Service.	R.95-04-043
Order Instituting Investigation on the Commission's Own Motion Into Competition for Local Exchange Service.	I.95-04-044

DECLARATION OF LEE L. SELWYN

prepared on behalf of

PAC-WEST TELECOMM, INC. (U-5266-C)
and
WORKING ASSETS LONG DISTANCE (U-5233-C)

August 23, 2001

REDACTED VERSION

DECLARATION OF LEE L. SELWYN

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DECLARATION OF LEE L. SELWYN

Introduction and Summary

Lee L. Selwyn, of lawful age, declares and says as follows:

1. My name is Lee L. Selwyn; I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Suite 400, Boston, Massachusetts 02108. ETI is a research and consulting firm specializing in telecommunications and public utility regulation and public policy. My Statement of Qualifications is annexed hereto as Attachment 1 and is made a part hereof.

2. I have been asked by Pac-West Telecomm, Inc. and Working Assets Long Distance ("Joint Parties") to provide an assessment of the current state of competition in the California local telecommunications market, to address the critical role that structural separation between SBC-Pacific's wholesale and retail operations will play in assuring full *and ongoing* compliance by SBC-Pacific with all of the specific conditions set forth in the "Competitive Checklist" at Section 272(c)(2)(B) of the federal *Telecommunications Act of 1996* (the "Act" or "TA96"), and to provide an analysis of the potential impact upon competition in California's interLATA long distance market that would result from SBC-Pacific's entry into the long distance market while the Company continues to maintain overwhelming dominance of the local telephone service market in the state. In addition to my review of the application, testimony and supporting exhibits filed by SBC-Pacific in this and in the concurrent Section 271 proceeding, I have reviewed the Company's responses to data requests propounded by Pac-West and by Working Assets. Copies of the SBC-Pacific responses to which I will refer are provided in Attachments 2 and 3 to this Declaration.

3. In this Declaration, I show that despite long-standing legislative and regulatory efforts at both the federal and state levels to facilitate and encourage the development of effective competition in the local telecommunications market, California's dominant incumbent local exchange carrier, SBC-Pacific, persists in maintaining overwhelming dominance of both the residential and business segments. SBC-Pacific will likely continue to behave in an anticompetitive manner unless its own retail operations are separated from the wholesale provision of the underlying services, such that SBC-Pacific-retail would deal with the SBC-

Pacific-wholesale entity in exactly the same manner and on the same terms and conditions as any nonaffiliated retail service competitor. SBC-Pacific cannot reasonably be expected to comply, on an ongoing basis, with the 14-point "Competitive Checklist" unless full structural separation is fully pursued and implemented. Finally, I examine the impact upon competition in the California interLATA long distance market were SBC-Pacific permitted to offer this service while still maintaining its current level of overwhelming dominance in the local service market, and show that unless a serious and substantial change in the competitive local services landscape were to emerge quickly and irreversibly, SBC-Pacific will soon come to dominate and ultimately monopolize the adjacent, currently highly competitive, long distance market as well.

The combined effects of SBC-Pacific's overwhelming dominance of California's local telecommunications market coupled with its ability, upon obtaining Section 271 authority, to jointly market local and long distance services, will permit the Company rapidly to remonopolize the interLATA long distance market with minimal expenditures on marketing and advertising of this service, outcomes that are in direct and express violation of §709.2(c) of the California Public Utility Code.

4. Sec 709.2(c) of the California Public Utility Code provides that:

> No commission order authorizing or directing competition in intrastate interexchange telecommunications shall be implemented until the commission has done all of the following, pursuant to the public hearing process:
>
> (1) Determined that all competitors have fair, nondiscriminatory, and mutually open access to exchanges currently subject to the modified final judgment and interexchange facilities, including fair unbundling of exchange facilities,

as prescribed in the commission's Open Access and Network Architecture Development Proceeding (I. 93-04-003 and R. 93-04-003).

(2) Determined that there is no anticompetitive behavior by the local exchange telephone corporation, including unfair use of subscriber information or unfair use of customer contacts generated by the local exchange telephone corporation's provision of local exchange telephone service.

(3) Determined that there is no improper cross-subsidization of intrastate interexchange telecommunications service by requiring separate accounting records to allocate costs for the provision of intrastate interexchange telecommunications service and examining the methodology of allocating those costs.

(4) Determined that there is no substantial possibility of harm to the competitive intrastate interexchange telecommunications markets.

5. For the various reasons set forth below, it will not be possible for the Commission to assure that all of the specific competitive protections mandated by Section 709.2(c) are satisfied on a continuing basis following SBC-Pacific's entry into the in-region interLATA long distance business *so long as SBC-Pacific is permitted to pursue its retail local and long distance business and underlying network operations on an integrated basis.* Only through full structural separation, in which SBC-Pacific's retail organization is required to acquire the underlying network services from a separated SBC-Pacific wholesale entity on the same terms and conditions and by means of the same interfaces as its nonaffiliated retail competitors can the Commission make the affirmative determinations that it is required to do under the statute.

6. The *source* of SBC-Pacific's ability to exercise market power in the long distance market *while it holds a near-monopoly in the local market* stems from its opportunity, under Section 272(g) of the *Telecommunications Act of 1996* ("TA96" or the "Act"), to engage in "joint marketing" of its long distance and local services. As I shall discuss in more detail below, several FCC rulings have expanded the "joint marketing" concept (which, in my view, implies the right of a BOC and its long distance affiliate to collaboratively ("jointly") participate in marketing activities with respect to their respective local and long distance offerings) to expressly permit BOCs with Section 272 long distance affiliates to preemptively "recommend" ("sell") their own affiliate's long distance service to *local service* customers who contact them to initially order *local* service or for other purposes related solely or primarily to matters involving *local* service. Only in those instances where the "inbound" local service customer expressly asks about other long distance providers will the BOC service representative then offer to read a (lengthy) list of non-affiliated interexchange carriers (IXCs) that also provide such services. Experience in both New York and Texas, the first two states in which BOCs have obtained Section 271 authority, confirms the extraordinary marketing advantage, *available solely to BOCs*, stemming from their use of this "inbound channel", an advantage that has not been overlooked by Wall Street. Marketing scripts and sales training materials provided by SBC-Pacific in response to Working Assets Data request 1-1.a confirm the fact that, upon receiving interLATA authority, SBC-Pacific intends to and will engage in **<<BEGIN PROPRIETARY**

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activities that are *directly and expressly prohibited* by §709.2(c)(2). As a February 8, 2001 Credit Suisse First Boston ("CSFB") report commented:

> We've been watching this industry for almost 20 years and we have never seen consumer share gained at the rate of VZ in NY and SBC in TX (the former 20% share in 12 mos and the latter 18% share in 6 months).[1]

More recently, the *San Jose Mercury News* observed that

> In California, the long-distance market is estimated to be $16 billion a year. With more than 90 percent of the state's residents paying Pac Bell a monthly local phone bill, SBC has ready access to millions of potential customers.[2]

In considering whether SBC-Pacific has satisfied the requirements of §709.2(c), it is essential that the Commission recognize that what is being sought here by the Company is not simply the right to enter yet another isolated line of business, but the right to *integrate* local and long distance service into a single package, to make the two services essentially indistinguishable from the consumer's perspective, and to leverage its dominance of the local market to similarly come to dominate the long distance market as well. CSFB makes the point profoundly clear in its comparison of (pre-merger) GTE's approach to selling long distance services through a separate CLC affiliate vs. Verizon's and SBC's ability to offer long distance services directly to their ILEC customers:

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1. "VZ: Analyst Mtg Provides Comprehensive '01 Outlook," Credit Suisse First Boston, 09:47am EST, 8-Feb-01 ("*CSFB Report*").

2. "FCC reviews SBC over false data, Firm to delay filing California application for long distance," *San Jose Mercury News*, June 16, 2001.

> In stark contrast to Verizon's huge and quick 20% consumer LD share gains in NY State, LD subscribership was flat in the GTE franchise areas in '00 despite GTE's benefiting from similar pre-established branding and billing relationships. The difference is that GTE has not leveraged the inbound channel and also had been running its LD effort through its "CLC", in effect forcing customers to switch to the GTE CLC both their local service from GTE's ILEC and their LD service from another LD customer. Not very successful if you ask us and certainly worthy of change given the empirical evidence that VZ's and SBC's use of the inbound channel and separate LD sub (but not bundled with local) have been extraordinarily successful.[3]

7. This Commission has long been concerned with the impacts upon ratepayers and upon competition arising from transactions and other interactions between a regulated utility such as *and specifically including* SBC-Pacific and its nonregulated affiliates. In D.86-01-026 and on a number of occasions since, the Commission has established the overarching standard of "ratepayer indifference" with respect to such transactions, interactions and relationships, requiring that in no event may ratepayers be made worse off as a result of the affiliate relationship than in its absence. As the documents provided by SBC-Pacific in this proceeding unambiguously establish and confirm, the specific joint marketing activities contemplated by SBC-Pacific following its Section 271 approval will financially harm SBC-Pacific Bell and have the potential to **<<BEGIN PROPRIETARY**

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3. *Id.*

8. The Commission has long contemplated the potential for precisely this type of self-dealing, and nearly fourteen years ago made clear its vision as to how it wanted utilities in California to address these concerns:

> Ultimately, it will be management's decision that determines the future path of diversification and affiliate transactions. A high road result will most probably come from management decisions that structurally separate regulated and unregulated operations, protect the regulated and unregulated operations, protect the regulated company's name, identity, capital, personnel, technology, "know how" and business income and pay a fair price for all interests of value received by the affiliate from the regulated company. The "other road" is full of uncertainties and other dangers caused by confusion of the regulated company's property and interests with the business of the affiliate. We prefer the high road because it is the smooth and sure road into the future.[4]

As the documents produced by SBC-Pacific make abundantly and unambiguously clear, SBC-Pacific has chosen to pursue this "other road."

9. For the very reasons and concerns as expressed by the Commission in this 1987 ruling, I do not believe that it will be possible for SBC-Pacific to satisfy *either* the Commission affiliate relationship rules *or* the express requirements of §709.2(c) without full structural separation of its wholesale (network) operations from its retailing activities. A structural separation model will work to create a more "level playing field" not just with respect to local service competition but with respect to long distance services as well. SBC-Pacific will acquire huge and essentially insurmountable marketing advantages if it is permitted to offer long distance services under the same fully integrated model that exists

4. D.87-12-067, 27 CPUC2d 1, 141.

today. There is no practical means by which SBC-Pacific can satisfy either this Commission's affiliate rules, the California Public Utility Code requirements, or the Section 271(c)(2)(B) "Competitive Checklist" and the Section 271(d)(3)(C) "public interest" showing in the absence of full and effective structural separation. For this reason, it is critical that the Commission expressly condition its support for SBC-Pacific's Section 271 authority upon the Company's full implementation of structural separation.

Pacific continues to hold an overwhelming share of the local service market in California, a condition of persistent market dominance that belies SBC-Pacific's claim that the California local exchange service market is "open to competition."

10. The *Modification of Final Judgment* ("MFJ"), the 1982 Consent Decree under which the former Bell System was broken up and the Bell Operating Companies ("BOCs") were divested from AT&T,[5] prohibited the divested BOCs from offering interLATA long distance services. This *structural remedy* was adopted in order to prevent the BOC local service monopolies from using their monopoly market power in the local services market to block competition in the adjacent long distance market. And because the BOCs were themselves precluded from providing long distance services, they were made to be *indifferent* as to which long distance carrier their customers might individually select. Section 271 of the federal *Telecommunications Act of 1996* established a process by which BOCs could enter the "in-region" long distance market, provided that they implemented a series of specific measures that would have the effect of irreversibly opening their previously monopolized local

5. *U.S. v. Western Electric Co. et al.*, 552 F. Supp. 131 (D. D.C., 1982), *aff'd sub nom. Maryland vs. U.S.*, 460 U.S. 1007 (1983); and *Modification of Final Judgment*, sec. VIII.B.

telecommunications markets to competitive entry. To the extent that the *local* market itself becomes competitive, the BOCs' ability to exert market power in the adjacent long distance market would be attenuated. §709.2(c)(1) goes directly to this same concern, requiring that the Commission, prior to permitting SBC-Pacific to offer interLATA services within California, to first have "[d]etermined that all competitors have fair, nondiscriminatory, and mutually open access to exchanges currently subject to the modified final judgment and interexchange facilities, including fair unbundling of exchange facilities, as prescribed in the commission's Open Access and Network Architecture Development Proceeding (I. 93-04-003 and R. 93-04-003)."

11. History is of course repeating itself. Two decades ago, the former Bell System was confronted with nascent competition from "Other Common Carriers" ("OCCs") seeking to compete in the long distance market. But in order to provide their services, OCCs needed to interconnect their long distance networks with the Bell Companies' local networks so as to reach individual subscribers. However, at that time the Bell companies were themselves the dominant long distance service provider, and so had inherent financial and business incentives to — and did — limit those rivals' access to the monopoly local networks. Specifically, competing OCCs were afforded substantially inferior access relative to that which the Bell companies provided for their own long distance service, including the requirement that OCC customers dial many additional digits to complete a long distance call.

12. The solution was a dismemberment of the integrated Bell System into local Bell Operating Companies ("BOCs") that were subject to specific "line of business restrictions" *prohibiting* them from providing long distance services, and AT&T, which was to operate the long distance network. Coupled with the divestiture was a mandate that BOCs provide "equal access" to all interexchange carriers (IXCs), a process whose implementation began almost immediately following the January 1, 1984 break-up and that was substantially completed in a little over five years. The break-up of the former Bell System made the divested BOCs both *financially and competitively indifferent* as to which IXC purchased and used their "access services." Without an inherent incentive to provide preferential treatment to AT&T, the non-AT&T IXCs were able to compete with the incumbent long distance carrier on an equal basis and, in so doing, to acquire a substantial fraction of the interLATA long distance market.[6]

13. But the break-up of the former Bell System did not occur until nearly a decade after the onset of competition in the switched long distance market which, prior to the break-up, was having a great deal of difficulty getting started. The present situation with local service competition is a direct parallel, and the lessons learned from the long distance situation twenty years ago are equally applicable here.

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6. For example, from 1984 to 1989 (when equal access was substantially complete), AT&T's share of the interLATA toll market had decreased from 90.1% to 67.5%. As of 1999, AT&T's share had dipped to 40.7%. FCC, Industry Analysis Division, Common Carrier Bureau, *Trends in Telephone Service*, December 2000, at Table 10.8.

14. There are strong and obvious parallels here with the 1984 Bell System break-up. At that time, the prevailing view was that local service (including the subscriber line and the local interoffice switching and transport network) was a "natural monopoly" while long distance service, customer premises equipment, information services, and equipment manufacturing were all either competitive or potentially competitive. The structural remedy that was adopted at that time was to separate the monopoly business segment from the competitive business segments, thereby eliminating altogether the monopolist's incentive and its ability to favor an affiliate in a business segment in which competition is possible. In the intervening decades, the scope of the telecommunications "natural monopoly" has narrowed, and is now generally recognized as being largely limited to what is colloquially referred to as the "last mile," i.e., the distribution facilities running between individual customer premises to the ILEC "wire center," and various other network and corporate functions that possess high degrees of integration economies with that "last mile."

15. The notion underlying Section 271 of the 1996 federal *Act* is that once the local exchange market becomes competitive such that consumers have a real choice with respect to local service provider, no one local service provider would possess a monopoly in this segment and thus be capable of leveraging that monopoly to similarly monopolize and dominate the adjacent long distance market. Consequently, in its June 27, 2001 Section 271 filing with this Commission, SBC-Pacific undertakes, through the declaration of David Tebeau of SBC, to demonstrate the presence of significant competition in the California local service market. Mr. Tebeau presents an examination of the state of competition in SBC-

Pacific Bell's service area. Using three different methods, Mr. Tebeau claims the SBC-Pacific Bell is currently operating in a market in which CLCs are positioned to serve most if not all existing customers. Were that the case — which as I shall show it clearly is not — SBC-Pacific could presumably claim that its service area was significantly opened to competition. The validity of Mr. Tebeau's methods for determining levels of competition and CLC competitive potential is therefore integral to this proceeding. As I shall demonstrate, the various claims and assertions advanced by Mr. Tebeau serve only to confirm SBC-Pacific's ongoing and overwhelming dominance of the California local service market. In addition, I am providing as Attachment 4 to this Declaration a study entitled *Assessing SBC/Pacific's Progress in Eliminating Barriers to Entry* that my firm, Economics and Technology, Inc., prepared in August 2000 for the California Association of Competitive Telecommunications Companies (CALTEL). The purpose of the study was to evaluate the status of local competition in California and to determine whether local competition is even possible in SBC-Pacific's market. Our study demonstrated that new entrants had made only minimal inroads into SBC-Pacific's dominant market position, and that the absence of meaningful market penetration was a direct consequence of the persistence of the same basic entry barriers that were present prior to the 1996 law. I would note that the ETI study was conducted and completed *prior* to the onset of serious investor disillusionment in CLC stocks and bankruptcies that began in the fourth quarter of 2000 and, if anything, the potential for significant competitive growth is even lower today than it was last year when the study was conducted.

16. SBC-Pacific's pervasive dominance of the local telecom market could be due to affirmative efforts by SBC-Pacific to impede competition, or it could be the result of inherent difficulties in actually competing with an entrenched monopoly possessing an installed base of network assets that took more than a century of protected monopoly to acquire and develop, or perhaps both of these reasons. Significantly, SBC-Pacific has made no showing concerning the amount of local competition in its § 709.2 filing. Its Tebeau material, filed in the Section 271 proceeding also fails to make such a showing for the reasons I discus below.

17. Given the immense amount of capital that has been invested by firms seeking to enter the California local services market and the effort that has been expended by these firms to pursue that goal, if SBC-Pacific had truly "opened its network" to competitive access and entry we should be observing far more competitive activity than even Mr. Tebeau's exaggerated account seeks to portray. Indeed, even Mr. Tebeau concedes that SBC-Pacific's share of the local service market in its operating areas in California may be as high as 94%,[7] and asks the Commission to accept the idea that a mere 6% level of competitive penetration after more than five and a half years following enactment of TA96 constitutes an effectively competitive market. If SBC-Pacific's network were truly open and accessible to CLCs, the competitive nature of the local service market in California would not even be a matter of dispute or debate. Mr. Tebeau himself thus provides compelling evidence that competitors do *not* "have fair, nondiscriminatory, and mutually open access to exchanges currently subject to the modified final judgment and interexchange facilities, including fair unbundling of

7. Tebeau (SBC-Pacific), at Table 1.

exchange facilities, as prescribed in the commission's Open Access and Network Architecture Development Proceeding (I. 93-04-003 and R. 93-04-003)," as required by §709.2(c)(1).

18. The most clear and direct way to measure a CLC's market penetration is the count the access lines that it is actually serving. Theoretical "analyses" of "potential" CLC capacities/market penetrations are highly speculative and, in light of the spate of recent CLC failures, cannot be advanced as any sort of demonstration that the market is irreversibly opened to competition. An "access line" for this purpose is a physical voice-grade equivalent facility providing dial tone to an end user customer. In fact, SBC-Pacific has no direct means of counting the actual number of access lines currently being provided by facilities-based CLC providers and thus has resorted to various types of "shadow" evidence that Mr. Tebeau undertakes to "interpret" as conveying far more market intelligence than it actually does.

19. One such "shadow" approach is to extract certain information from the E911 database that Pacific Bell is responsible for managing,[8] and to integrate those results with

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8. In this regard and as an aside, Pacific Bell's use of the E911 data base to extract market information is in itself evidence of an abuse of its monopoly position. Apparently, Pacific is able to obtain extremely granular market data about its competitors' activities from this data source that it exclusively controls. By mining the E911 database and assuming that it is sufficiently accurate for the conclusions being drawn by Mr. Tebeau to be valid, Pacific apparently can identify the quantity of access lines being provided by each of its CLEC competitors in each exchange area — the type of information that Pacific characterizes as "third party proprietary data" in both its prefiled evidence as well as in responses to data requests. While this information is not being furnished to Pacific's competitors, Pacific is apparently making liberal use of the very same "third party proprietary" market data for its own competitive and strategic purposes, such as its use in this proceeding to buttress is efforts

(continued...)

other "shadow" data to which Pacific Bell has access, such as the number, location, and carrier for interconnection trunks and collocation arrangements. Through discovery, however, it is apparent that each of Mr. Tebeau's methods involve assumptions or distortions that seriously inflate this important competitive indicator.

20. Mr. Tebeau initially portrays the E911 database as a "conservative" source of CLC access line counts. By summing all numbers entered in the database identified by CLC NXX codes, and then adding the number of UNE-P access lines, Mr. Tebeau claims to present what he characterizes as an "overly conservative" estimate of CLC facilities-based lines. When queried in discovery, however, it becomes clear that Mr. Tebeau made no attempt to determine the actual occurrence of any theory that would justify characterizing this estimate as "conservative," much less "overly conservative." Mr. Tebeau could produce no practices manual or other documentation detailing CLC procedures for entering information into the E911 database. More importantly, however, Mr. Tebeau failed to explain in his declaration that the E911 database is not a listing of access lines. For example, in response to a Pac-West data request, Mr. Tebeau states that he made no attempt to explain or account for CLC practices with respect to the treatment of Direct Inward Dialing (DID) numbers assigned to customers, which would typically exceed the actual number of access lines that the customer

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8. (...continued)
to obtain Section 271 authority. Inasmuch as Pacific does not make this information available to its competitors while at the same time utilizing it for its own purposes, the practice is on its face competitively unfair.

obtains from a CLC.[9] Contrary to Mr. Tebeau's speculation, the quantity of CLC-associated numbers in the E911 database could well be significantly greater than the actual number of CLC lines in service. This is due to common business communications arrangements such as DID, where each station line "behind" a PBX is assigned its own unique 7-digit telephone number. A DID customer will obtain a block of numbers from its local carrier, ILEC or CLC, and that quantity of individual numbers will typically be a multiple of the quantity of physical access lines (PBX trunks) that are being provided to that customer. For example, FCC rules relating to surcharges for Local Number Portability ("LNP") allow an ILEC to apply nine (9) LNP charges for each PBX trunk or equivalent; thus, in the case of a T-1 trunk containing 24 individual voice channels, the FCC LNP rules contemplate 24 x 9, or 216 PBX stations "behind" the single T-1 facility.[10] Although carriers do not necessarily report all DID numbers to the E911 data base, their individual practices in this regard are not uniform and, in any event, are not known and were not researched by Mr. Tebeau or by SBC-Pacific.[11] DID numbers would require E911 presence if the customer's PBX was capable of identifying the calling station line on outgoing calls. While this "Identified Outward Dialing" ("IOD") capability is by no means universally present, the CLC has no consistent means of determining the capabilities of its customers' PBXs and, in an abundance of caution, may

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9. SBC-Pacific response to Pac-West data request 1-8.b.

10. 47 CFR Part 52, subpart 33(i).

11. SBC-Pacific response to Pac-West data request 1-8.b.

include all of the numbers in the DID number block in its E911 entry for that customer.[12] If in fact the "CLC E911 number counts" that Mr. Tebeau interprets as CLC *access lines* include DID numbers, the CLC market share figures that he presents based thereon would be seriously exaggerated.

21. Mr. Tebeau's second "shadow" data source uses the number of interconnection trunks being provided to CLCs by SBC-Pacific in order to estimate the number of CLC access lines. Interconnection trunks provide a connection between the CLC's network and SBC-Pacific's network. The number of interconnection trunks needed is determined by the amount of traffic to and from each communications network. Mr. Tebeau explores several alternative trunk-to-line ratios, indicating that the actual number of lines per trunk will vary based on specific customer traffic load. The number he adopts is 2.75, an unrealistically high number considering CLC circumstances and previous Department of Justice recommendations.[13] Unlike ILECs that have the existing customer base to justify fully efficient use of trunks,

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12. Pending FCC rules would require PBXs to have the IOD capability for E911 purposes at least with respect to a limited number of PBX station lines. *In the Matter of Revision of the Commission's Rules to Ensure Compatibility with Enhanced 911 Emergency Calling Systems*, CC Docket 94-102, 9 FCC Rcd 6181, at para. 60.

13. See Comments of the United States Department of Justice at fn. 15, *Application by SBC Communications, Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance for Provision of In-Region InterLATA Services in Texas*, CC Docket No. 00-4 (FCC filed Feb. 14, 2000). CLECs that specialize in serving customers with high-volume inward calling requirements will typically engineer their networks at a 1:1 concentration ratio, implying one interconnection trunk for each one customer access line. As the current controversy at both the CPUC and the FCC over "reciprocal compensation" attests, this segment represents a major fraction of total CLEC business.

CLCs target individual customers and will install interconnection trunks for just one customer if the situation warrants. Additionally, CLCs handle unusual customers, such as ISPs, that require a higher number of interconnection trunks relative to the number of access lines provided by the CLC to such customers. Thus, the capacity of CLC trunks bears no predictable relationship to the number of customer lines served over a CLC network.

22. SBC-Pacific's records indicate that the Company has experienced little or no real competition when the trunk-to-line ratio is set at the more realistic 1:1 ratio. Comparing SBC-Pacific access lines growth with CLC access lines estimated with a 1:1 ratio shows that CLCs have to date succeeded in capturing only part of the market growth. Using these estimates, CLCs have captured only 6% market share, less than the growth of demand generally.[14]

23. In addition to estimating CLC access lines, SBC-Pacific includes what is at best a highly speculative estimate of "potential" CLC competition in its portrayal of the CLC market position. Purporting to rely upon a proprietary "CLEC Report, 13th edition" published by New Paradigm, Mr. Tebeau claims that "CLECS have already installed enough switching capacity in California to serve over 88% of Pacific Bell access lines in the State."[15] In fact,

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14. See Tebeau (SBC-Pacific), at Tables 1 and 5. Using these estimates of CLC access lines and the SBC-Pacific access line figures provided in Mr. Tebeau's Table, CLCs have captured 1.116-million of the 19.6-million total 2001 Pacific Bell and CLC access lines in Pacific Bell's service area.

15. *Id.*, at para. 1, emphasis supplied.

nowhere is any information of this type contained in the New Paradigm report that Mr. Tebeau cites as the "source" for his contention; Mr. Tebeau thus has no idea as to how much "switching capacity" California CLCs have installed.[16] The New Paradigm report only identifies the manufacturer and model number for some but not all CLC switches, but contains no information whatsoever on the *installed* capacity of these systems. Central office-grade switches can be configured in capacity sizes ranging from a few thousand to more than one hundred thousand lines. In advancing his claim that CLCs have "already installed" switch capacity capable of serving 88% of all customers in the SBC-Pacific service area, Mr. Tebeau appears to have simply applied the theoretical maximum capacity of each switch type and then multiplied those theoretical amounts by the number of CLC switches identified in the New Paradigm report. The results of this "analysis" are a pure fabrication, and in no way support his assertion that "CLECs have already installed" the quantity of switch capacity that he claims to exist.

24. In fact, it would make no sense for CLCs in California to have collectively acquired switch capacity capable of serving somewhere in the range of 15-million lines when, by Mr. Tebeau's own exaggerated account, their existing customer base is less than 1.116-million (and is probably a good deal smaller than that).[17] Indeed, to get from a capacity level sufficient to support the market share that Mr. Tebeau ascribes to them to the 15-million line level he claims that CLCs have "installed," CLCs would need to invest billions of dollars for

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16. SBC-Pacific response to Pac-West data request 1-1.f.

17. Tebeau (SBC-Pacific), at Table 1.

the switching equipment alone, not to mention billions more in organizing themselves to serve 15-million customer lines. In all, CLCs would collectively be required to commit far more incremental capital to get from their current capacity level to that suggested by Mr. Tebeau than they currently have invested in their California operations. Mr. Tebeau admitted that he had not examined either the amount of capital that would be required for CLCs to reach this capacity level,[18] nor had he made any assessment as to the availability of such sums to CLCs that might want to make such investments[19] (which of course they would not, because expanding to the capacity claimed for them by Mr. Tebeau would be instant suicide). Citing manufacturers' theoretical maximum capacity specifications as constituting *actual installed CLC switching capacity* teaches absolutely nothing about actual or potential CLC ability to provide service in SBC-Pacific's operating areas.

25. To clarify his understanding as to what constituted the "actual CLEC access line coverage," Mr. Tebeau was asked to provide information on the current capacity of CLC switches as well as capital required and steps necessary to upgrade CLC switches to the capacity level he claims to exist. Mr. Tebeau had no such information,[20] nor was it included in the New Paradigm CLEC Report, his source for this assertion. What was included in the

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18. SBC-Pacific response to Pac-West data request 1-1.g.

19. SBC-Pacific response to Pac-West data request 1-1.i.

20. SBC-Pacific response to Pac-West data request 1-1.g, 1-1.h.

New Paradigm Report, however, was the fact that capital resources have become scarce for CLCs.[21]

26. Another "shadow" approach that Mr. Tebeau used to estimate CLC competitive potential was to offer the number of completed collocation arrangements as a "strong" indicator of both the existence of and potential for facilities-based competition.[22] Mr. Tebeau cited 3,253 collocations in 348 wire centers, and based thereon asserted that a significant number of CLCs are positioned to directly compete with SBC-Pacific.[23] The strength of potential competition, however, is mitigated significantly when the number of failing CLCs is considered. According to SBC-Pacific's own records, a full **<<BEGIN PROPRIETARY END PROPRIETARY>>** collocations — more than **<<BEGIN PROPRIETARY END PROPRIETARY>>** of the total cited by Mr. Tebeau — currently have a payment due to Pacific for the collocation space that is more than 60 days past due.[24] Additionally, SBC-Pacific has also admitted that it has received discontinuation orders for **<<BEGIN PROPRIETARY END PROPRIETARY>>** existing collocation arrangements.[25] Thus, as many as **<<BEGIN PROPRIETARY END PROPRIETARY>>** of the 3,253 CLC collocations that Mr. Tebeau claims to exist pose no

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21. New Paradigm Research Group, "CLEC Report 2001" 13th Edition, 2000, ch. 1, p. 1.

22. Tebeau (SBC-Pacific), at para. 30.

23. *Id.*, at para. 31.

24. SBC-Pacific response to Pac-West data request 1-4.

25. SBC-Pacific response to Pac-West data request 1-3.d.

serious competitive threat to SBC-Pacific, since they are unlikely to have a long-term potential for survival.

27. Moreover, some (albeit unspecified) of the collocation arrangements cited by Mr. Tebeau are undoubtedly associated with "data CLCs," i.e., carriers providing Digital Subscriber Line (DSL) services. Not unlike entering the local phone service market, these other service areas are proving to be expensive modes of entry, due to high fixed costs associated with acquiring the necessary facilities. A compelling demonstration of the prevailing dearth of confidence in the data CLCs' ability to successfully develop their networks and even to expand into voice-over-IP service base can be seen in the decision last year by Verizon to pull out of its plans to acquire a 55% stake in NorthPoint Communications. Following this decision, a Verizon spokesperson claimed that the Company had "several other ways" of gaining customers in the DSL markets outside of Verizon's traditional territory.[26] In March 2001, AT&T acquired the *physical assets* of NorthPoint for about $135-million, less than 10% of the pre-Verizon-merger market value of NorthPoint as a going concern, and only about "'25 cents on the dollar' ... for NorthPoint's 'hard assets.'"[27] In fact, certain data CLCs, such as Covad and Rhythms NetConnections, are already operating under Chapter 11 protection.[28]

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26. "Citing Declining Operations, Financial Results, Verizon Backs Away From Takeover Of NorthPoint," *TR Daily*, November 29, 2000.

27. *Telecommunications Reports*, March 26, 2001; *TR's Last-Mile Telecom Report*, August 8, 2000.

28. *TR Daily*, August 2, 2001; August 15, 2001.

28. A June 18, 2001 *New York Times* analysis of the fiber optic long-haul "backbone" market underscores the utter lack of competition at the *local* distribution end of the information superhighway:

> There is a glut of capacity of high-speed, long-haul information pipelines, but a shortage of the high-speed local-access connections that consumers and businesses need to connect to the Web. It is as if superhighways stand nearly empty while traffic backs up at the Holland and Lincoln tunnels.
>
> Few people have fast Internet connections, and prices are rising for those who do. ...[29]

Ironically, while the demand for bandwidth is clearly present and growing, the ILEC-controlled local access monopoly is working effectively to block that demand from ever reaching the overabundant supply. Given the tens of billions of dollars that have been invested in backbone fiber, one would certain expect that, were realistic competitive opportunities actually available in the local service market, at least some of that investment capital would have been and would even today be deployed in this direction. The fact that the local ILEC bottleneck persists and investors are running away from pursuing local service entry as fast as they can speaks volumes about the actual state of local competition both nationally and more specifically in California, where demand for Internet access is perhaps the highest in the world. One might even go so far as to theorize an affirmative business strategy on the part of SBC, Verizon and the other RBOCs to deliberately withhold the availability of high-speed Internet access so as to enfeeble the backbone fiber optic network

29. "Once-Bright Future of Optical Fiber Dims," *New York Times*, June 18, 2001, p. A1.

providers to the point where, following their attainment of Section 271 authority, the RBOCs will be in a position to purchase those backbone network assets at fire-sale prices.

29. Indeed, one need look no further than the recent actions of SBC and Verizon for confirmation of the extreme difficulties that entrants confront in competing with ILECs in the local services market. SBC, in its Joint Application for approval of its merger with Ameritech,[30] and Verizon, in its Joint Application for approval of its merger with GTE,[31] represented that following their respective mergers the two mega-ILECs would each commit to pursuing "out-of-region" entry in various local exchange service markets. SBC had identified thirty such markets (of which 12 would be in what would become Verizon territory),[32] while BA/GTE (Verizon) committed to enter twenty-one markets, of which eleven would be in the expanded 13-state SBC region.[33] Although various parties and their experts, including myself, expressed serious doubts as to the legitimacy of these so-called "commitments," both sets of joint applicants insisted that their respective "national local

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30. *In re: Applications of Ameritech Corp., Transferor, and SBC Communications, Inc., Transferee, for Consent to Transfer Control of Corporations Holding Commission Licenses and Lines Pursuant to Sections 214 and 310(d) of the Communications Act and Parts 5, 22, 24, 25, 63, 90, 95, and 101 of the Commission's Rules*, CC Docket No. 98-141, Application at Sec. II.A.1.

31. *Applications of GTE Corporation and Bell Atlantic Corporation, Description of the Transaction, Public Interest Showing and Related Demonstrations*, CC Docket No. 98-184 (October 2, 1998), Declaration of Jeffrey C. Kissell, at para. 14.

32. SBC/Ameritech Application, Attachment A: "New Markets for the New SBC"

33. Bell Atlantic/GTE Application, Declaration of Jeffrey C. Kissell, at para. 14.

strategies" would be aggressively pursued and would result in a significant enhancement of local competition throughout the country.[34]

30. In its Orders approving the two mergers, the FCC undertook to put some teeth into what were in other respects "soft" commitments on the part of the two sets of merger parties with respect to their out-of-region local entry plans. In its *SBC/Ameritech Order*, the Commission *required* the promised entry, and indicated that the post-merger SBC would be fined as much as $39.6-million for each of the 30 out-of-region markets that it did not enter.[35] In the *BA/GTE Order*, the FCC similarly imposed the threat of fines if BA/GTE failed to invest at least $500-million in out-of-region CLC activities, or provided service as a CLC to at least 250,000 customer lines, by the end of 36 months following the merger closing date.[36]

31. As it has turned out, of course, the skepticism of various commenters and the concerns of the FCC with respect to the veracity of these out-of-region local entry

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34. *Id.*, at para. 15; SBC/Ameritech Application, Affidavit of James S. Kahan, at para. 27.

35. SBC/Ameritech Merger Order, FCC 99-279, October 6, 1999, at Appendix C, para. 59(d). "If an SBC/Ameritech Out-of-Territory Entity fails to satisfy any of the 36 separate requirements for each out-of-territory market on or before the deadlines set forth in Subparagraph c, SBC/Ameritech shall make a one-time contribution of $1.1 million for each missed requirement (up to a total contribution of $39.6 million per market and $1.188 billion if SBC/Ameritech Out-of-Territory Entities fail to satisfy all 36 requirements in all 30 markets) to a fund to provide telecommunications services to underserved areas, groups, or persons."

36. *BA/GTE Merger Order*, at paras. 43-48.

"commitments" were well-founded. Earlier this year, both SBC and Verizon announced that they had each abandoned or drastically scaled-back their out-of-region local entry plans.[37] Significantly, Verizon is both the largest local telephone company in the United States *and* has a significant presence as an *ILEC* in California, serving some 4.8-million access lines[38] in territories that are both proximate and in most cases contiguous to those served by SBC-Pacific. If ever there was a candidate for successful entry into SBC-Pacific's territory as a CLC it is Verizon, yet Verizon has elected not to pursue out-of-footprint California entry.

32. There are a number of interpretations and explanations that may be offered for these decisions on the part of SBC and Verizon not to compete in each other's home turf, but none of them offer much confidence in the potential for the development of actual competition in the California local service market *notwithstanding purportedly nominal compliance on the part of SBC-Pacific with the Section 271(c)(2)(B) "checklist."* One scenario involves either a tacit or overt market allocation on the part of the two companies. While outright collusion is course theoretically possible, it would certainly not be necessary in order for each firm to signal its intentions to the other — *you stay out of my territory and I'll stay out of yours.* Or the two RBOCs could simply have come to the same conclusion that many CLCs and investors have reached — that competing with an incumbent LEC is extraordinarily difficult and is unlikely to result in either significant market penetration or profit growth in the long

37. *TR Daily*, January 15, 2001, March 21, 2001.

38. ARMIS 43-08.

run. Either way, the Commission can hardly premise approval of SBC-Pacific's Section 271 application on the remote possibility that competition might actually develop *someday*.

33. In the five-year period following enactment of TA96, various mergers have been approved among large incumbent LECs that have reduced the number of Regional Bell Operating Companies (plus GTE) from eight to four. At the outset of each of these mergers, these large carriers have promised that their combination would further the pro-competitive purposes of the Act. Based upon the competitive entry data set forth above, it is clear that, both in California and on a national scale, these mergers have done nothing but create larger, better financed bottleneck monopolies. Indeed, the RBOCs' resistance to the market opening conditions of the Act has proven so successful that the competitive local exchange carrier industry now stands on the verge of collapse.[39]

34. Competitive LECs have become marginalized because they do not own the strategic assets necessary to compete, and must instead rely upon the ubiquitous Bell network, a network that remains largely closed to new entrants, Sections 251 and 252 notwithstanding. There has been carnage among CLC stocks, and numerous competitive LECs have filed or are

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39. AT&T has made this very case in the past. *See*, e.g., *In the matter of Joint Application of Onepoint Communications Corp. and Verizon Communications for Authority Pursuant to Section 214 of the Communications Act of 1934, as Amended, to Transfer control of Authorizations to Provide Domestic Interstate and International Telecommunications Services as a Non-Dominant Carrier*, CC Docket No. 00-170, AT&T's *Petition to Deny Joint Applications*, October 23, 2000.

on the verge of filing for bankruptcy.[40] From a financial perspective, many CLCs operating within California are experiencing a major economic downturn. The optimistic tone of the Tebeau declaration would have one believe that CLCs are stronger than they have ever been in their ability to capture market share, when in fact just the opposite is true.

35. That CLCs can expect to encounter substantial difficulty in raising capital is reflected in the recent sharp drop in their overall market capitalizations. CLC analysts at Morgan Stanley Dean Witter state that the market capitalization of CLCs as a group have fallen by 65.8% since January 1, 2001.[41] This figure does not account for the drop-off in CLC stock prices that began in the fourth quarter of 2000. As illustrated in Table 1 below, many of the carriers identified by Mr. Tebeau and the New Paradigm Report upon which he relies have experienced a precipitous drop in stock price and market capitalization over the past 22 months.

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40. As discussed above, NorthPoint filed for bankruptcy on January 16, 2001. Another DSL provider, HarvardNet, pulled out of the DSL market in December 2000. HarvardNet decided to restructure its business to focus on Web hosting, citing the capital intensive nature of the DSL market, as well as the "recent dramatic downturn in the financial markets" as reasons for discontinuing its DSL service. "DSL Providers NorthPoint, HarvardNet Cut Jobs," *TR Daily*, December 7, 2000. Additionally, and as previously mentioned, Covad and Rhythms have now also filed for Chapter 11 protection.

41. Morgan Stanley Dean Witter, Equity Research: North America, Industry: Competitive Local Exchange Carriers (CLCs), August 14, 2001, at 1. In an earlier report issued by MSDW, its analysts indicated that "[u]nlike the last two CLC market corrections, we do not believe that the current one is likely to end with the entire group rocketing back because, over the next six months, we expect news headlines to be peppered with reports of additional bankruptcies." Morgan Stanley Dean Witter, Equity Research: North America, Industry: Competitive Local Exchange Carriers (CLCs), November 7, 2000, at 2.

TABLE 1
CLC Market Capitalization

	September 30, 1999			August 8, 2001			
		In Millions			In Millions		
Company	**stock price**	**Shares out-standing**	**Market Cap**	**stock price**	**Shares out-standing**	**Market Cap**	**% change from 9/30/99 to 08/08/01**
Adelphia	$ 28.00	51.4	$ 1,439.7	$ 4.07	134.4	$ 529.4	-63%
Allegiance	$ 63.00	64.9	$ 4,086.5	$ 13.27	112.9	$ 1,550.0	-62%
AT&T Corp	$ 47.44	3195.6	$ 151,592.9	$ 19.90	3750.0	$ 76,400.0	-50%
Commonwealth Tele	$ 44.00	22.1	$ 972.8	$ 41.28	23.1	$ 993.0	2%
Connectiv	$ 19.63	87.3	$ 1,712.6	$ 22.97	88.6	$ 2,010.0	17%
CoreCom	$ 37.19	72.1	$ 2,679.4	$ 0.15	97.0	$ 15.6	-99%
CTC Communications	$ 16.44	14.6	$ 239.2	$ 5.53	26.7	$ 165.2	-31%
CTCI	$ 47.00	19.9	$ 936.5	$ 17.29	18.9	$ 315.2	-66%
Focal	$ 23.94	60.6	$ 1,451.7	$ 1.56	61.8	$ 102.0	-93%
Global Crossing	$ 26.50	794.8	$ 21,061.4	$ 6.48	886.5	$ 5,260.0	-75%
GST Telecomm Inc	$ 7.03	37.7	$ 265.2	$ 0.006	0.0	$ -	-100%
Northpoint	$ 24.31	125.2	$ 3,044.9	$ 0.04	133.5	$ 6.3	-100%
ICG Communications	$ 15.56	47.3	$ 736.8	0	0.0	$ -	-100%
Level 3 Communications	$ 52.22	341.1	$ 17,810.6	$ 4.33	368.2	$ 1,700.0	-90%
Worldcom	$ 76.88	1880.2	$ 144,541.8	$ 13.99	2950.0	$ 41,270.5	-71%
RCN	$ 49.69	76.2	$ 3,785.4	$ 4.66	87.7	$ 364.1	-90%
Sprint	$ 54.25	785.2	$ 42,597.4	$ 22.87	886.3	$ 20,200.0	-53%
Time Warner	$ 21.38	81.3	$ 1,736.7	$ 24.27	114.2	$ 2,910.0	68%
Winstar Comm Inc	$ 39.06	54.9	$ 2,145.9	$ 0.07	92.4	$ 6.2	-100%
XO Comm/Nextel	$ 61.38	315.5	$ 19,360.8	$ 2.00	372.2	$ 666.3	-97%
Total CLEC			$ 422,198.2			$ 154,463.8	-63%

Source: carrier 10Q reports, www.thedigest.com/stocks/

36. As Table 1 confirms, things have certainly not improved for CLCs over the past year. The dramatic decreases in CLC share prices indicate that (1) investors have less confidence in these companies' ability to succeed with business plans premised upon competing with ILECs; and (2) the companies themselves now will have much more difficulty attracting capital with which to pursue their business plans. Telecommunications is a high fixed-cost industry, and a lack of capital with which to pursue market entry will surely adversely impact a carrier's ability to gain market share, and may well drive some companies out of business (as it did for NorthPoint, Covad, Rhythms, and HarvardNet).

37. Lest there be any doubt that Wall Street's recent treatment of telecom stocks has been directed specifically at CLCs rather than at the telecommunications industry as a whole, RBOC shares have been performing quite respectively in light of current stock market conditions. As is shown in Table 2 below, RBOC stocks have been fairly well insulated from the recent downturn in the market, with market capitalization declining only 20% as a whole over the past 22 months. Investors and analysts thus remain far more confident that SBC and the other RBOCs will be successful in preserving their market positions and associated revenue streams, which obviously would include preserving their existing stranglehold over local service markets and, if provided the opportunity, the long distance market as well. In fact, industry officials and financial analysts indicate they did not expect the capital markets

TABLE 2
RBOC Market Capitalization

	September 30, 1999			August 9, 2001			
		In Millions			In Millions		
Company	**stock price**	**Shares out-standing**	**Market Cap**	**stock price**	**Shares out-standing**	**Market Cap**	**% change from 9/30/99 to 08/09/01**
BellSouth	$ 43.25	1885.0	$ 81,526.3	$ 39.45	1,880	$ 74,100.0	-9%
Ameritech	$ 67.88	1177.0	$ 79,888.9	-	-	-	-
SBC	$ 52.00	1967.0	$ 102,284.0	-	-	-	-
SBC post merger	-	3144.0	$ 182,172.9	$ 43.05	3,360	$ 144,100.0	-21%
Bell Atlantic	$ 69.50	1552.8	$ 107,918.6	-	-	-	-
GTE	$ 77.75	1002.2	$ 77,921.1	-	-	-	-
Verizon	-	2555.0	$ 185,839.7	$ 52.78	2,700	$ 143,500.0	-23%
US West	$ 59.19	485.0	$ 28,703.2	-	-	-	-
Qwest	$ 36.47	747.0	$ 27,242.2	-	-	-	-
Qwest post merger	-	1232.0	$ 55,945.3	$ 23.69	1,660	$ 40,200.0	-28%
Total RBOC			$ 505,484.2			$ 401,900.0	-20%

Note: US West 9/30/99 shares outstanding represents last reported shares outstanding of US West in April 1998
Source: Daily Stock Price Record, NYSE, Oct.-Dec. 1999, Standard & Poor's 2000, carriers 10Q reports

to open up anytime soon for most cash-starved CLCs, which is likely to force more CLCs to sell assets or go into bankruptcy.[42]

38. Approval of SBC-Pacific's entry into the long distance market *prior to the development of effective, price-constraining competition in the local market* exposes consumers and competitors in California to several serious risks:

(1) Whatever incentives the Section 271 "carrot" may provide SBC-Pacific to open its markets to competition will largely evaporate once interLATA authority is obtained, permitting the Company to "backslide," to slow or reverse altogether the market-opening measures it had pursued in order to satisfy the Section 271(c)(2)(B) "Competitive Checklist."

(2) Not only would the *local* market remain monopolized, SBC-Pacific would be able to extend its local monopoly into the adjacent long distance market, and work to *reduce* the level of competition that presently prevails with respect to long distance service.

(3) The result: Entry by new carriers into the California local market would be discouraged, existing competitive local service providers ("CLCs") would exit the market, long distance carriers would also exit the market as SBC-Pacific's long

42. "Facing "Fight of Our Lives', Nation's CLCs Seek to Ramp up Support in Congress, On Wall Street", *Telecommunications Reports*, December 11, 2000.

distance market share grows, and prices for both local and long distance service would inevitably increase.

39. While various SBC-Pacific declarants offer evidence purporting to demonstrate that SBC-Pacific has fully complied with all of the fourteen requirements set forth in the Section 271(c)(2)(B) "competitive checklist," the minimal level of competitive penetration that presently exists in California, even taking Mr. Tebeau's figures at their face value, belies those contentions. If the local service market were "irreversibly opened to competition" as SBC-Pacific contends, CLCs would be flocking to California — one of the most lucrative telecommunications markets in the world — rather than running from it. There is thus no basis upon which the Commission may reasonably determine, as required by §709.2(c)(1), "that all competitors have fair, nondiscriminatory, and mutually open access to exchanges currently subject to the modified final judgment and interexchange facilities, including fair unbundling of exchange facilities, as prescribed in the commission's Open Access and Network Architecture Development Proceeding (I. 93-04-003 and R. 93-04-003)."

Documents produced by SBC-Pacific confirm that, upon receiving Section 271 authority from the FCC, SBC-Pacific intends to engage in a "anticompetitive behavior by the local exchange telephone corporation, including unfair use of subscriber information or unfair use of customer contacts generated by the local exchange telephone corporation's provision of local exchange telephone service," behavior that is expressly prohibited by §709.2(c)(2).

40. Section 709.2(c)(2) requires that the Commission "[d]etermine[] that there is no anticompetitive behavior by the local exchange telephone corporation, including unfair use of subscriber information or unfair use of customer contacts generated by the local exchange telephone corporation's provision of local exchange telephone service." SBC-Texas has in fact engaged in precisely the types of activities that are prohibited by this section, *viz.*, the "unfair use of subscriber information or unfair use of customer contacts generated by the local exchange telephone corporation's provision of local exchange telephone service" in marketing its interLATA long distance services to its local exchange service customers in Texas. Marketing scripts and training materials produced by SBC-Pacific in response to Working Assets data request 1-1.a confirm that SBC-Pacific intends to pursue the very same fully integrated sales and marketing practices following receipt of its Section 271 authority in California: **<<BEGIN PROPRIETARY**

END PROPRIETARY>>[43] Lest there be any doubt as to SBC-Pacific's intention to make the same kind of "unfair use of subscriber information or unfair use of customer contacts generated by the local exchange telephone

43. SBC-Pacific response to Working Assets data request 1-1.a., Web-based Training 1, Sec. 6, screen 3 of 4.

corporation's provision of local exchange telephone service" in marketing its interLATA long distance services to its local exchange service customers in California, the Commission need only recall that as of the date of enactment of the *Telecommunications Act of 1996*, i.e., February 8, 1996, *SBC was permitted to provide interLATA long distance service in California* since, at that time, California was *not* part of the pre-merger SBC region.[44] SBC's entry into the (then) out-of-region California long distance market would not have afforded SBC any greater access to (then) Pacific Bell's local exchange service subscriber base than would have been available to any other long distance service provider, such as AT&T, MCI, Sprint, or Working Assets. The permissive legislation notwithstanding, *SBC chose not to enter the California long distance market as an interexchange carrier upon receiving authorization from the US Congress to do so.* Instead, SBC pursued a merger with SBC-Pacific Bell, expressly foregoing its opportunity for *immediate* long distance entry without the opportunity to leverage the ILEC subscriber base, for eventual long distance entry following Section 271 approval when it could pursue precisely that fully integrated joint marketing strategy.

41. That SBC-Pacific's marketing plans with respect to its long distance service are intimately linked to its local service customer base is further confirmed by the fact that SBC's policy in its other Section 271 states — Texas, Oklahoma and Kansas — is to limit the

44. Section 271(b)(2) provides that "A Bell operating company, or any affiliate of that Bell operating company, may provide interLATA services originating outside its in-region States after the date of enactment of the Telecommunications Act of 1996 ..."

availability of SBC long distance service to SBC local service customers only.[45] **<<BEGIN PROPRIETARY**

END PROPRIETARY>>[46] Thus, not only has SBC maintained its policy of not pursuing any out-of-region long distance entry, it apparently does not even offer long distance service either to CLC customers or to Independent ILEC customers *within the states in which SBC has received Section 271 authority*. Such revealed conduct compels the inescapable conclusion that not only does SBC-Pacific *intend* to make "unfair use of subscriber information [and] unfair use of customer contacts generated by the local exchange telephone corporation's provision of local exchange telephone service" in marketing long distance services in California, these opportunity to engage in these practices appears to be the sole driver of SBC's interest in the long distance business.

42. The potential for this very type of anticompetitive behavior on the part of (then) Pacific Bell with respect to joint marketing of its regulated local exchange services together with its long distance affiliate's competitive services was the subject of extensive discussion

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45. See Attachment 5 to this Declaration. This is a print-out of the response I received from the SBC website when I attempted to order SBC long distance service using a hypothetical telephone number in a Texas exchange not served by SWBT.

46. SBC-Pacific response to Working Assets data request 1-1.a, PBCL 011965.

during the *PB Com* proceeding.[47] In that application, which was filed by Pacific Bell in March of 1996, *just weeks after the 1996 federal Telecommunications Act became law*, the Company asked the Commission to issue a Certificate of Public Convenience and Necessity ("CPCN") permitting it to offer intrastate interLATA long distance service. Pacific Bell's actual entry into the California long distance market was, of course, still to be conditioned upon an FCC finding that the Company had complied with all of the requirements set forth at Section 271 of the federal *Act*. Given that holders of CPCNs are normally expected to commence providing service within 12 months following the date of issue of their Certificate, it would appear that Pacific Bell anticipated receiving its Section 271 authority from the FCC with little delay.

43. ALJ Walker issued draft Proposed Decisions ("PDs") in the PB Com case in May 1997[48] and in December 1998.[49] In the 1997 PD, the ALJ found that PB Com/PBLD was planning to attract long distance customers primarily through the use of its preexisting monopoly relationships with SBC-Pacific Bell local service customers. He concluded that this

47. *Application of SBC-Pacific Bell Communications for a Certificate of Public convenience and Necessity to Provide InterLATA, IntraLATA and Local Exchange Telecommunications Services Within the State of California*, Calif. PUC Application (A.) 96-03-007.

48. A. 96-03-007, *Application of SBC-Pacific Bell Communications for a Certificate of Public convenience and Necessity to Provide InterLATA, IntraLATA and Local Exchange Telecommunications Services Within the State of California* ("PB Com"), *Proposed Decision of ALJ Walker*, May 5, 1997 ("*1997 Proposed Decision*").

49. *PB Com*, A.96-03-007, *Proposed Decision of ALJ Walker*, December 9, 1998 ("*1998 Proposed Decision*").

exploitation of SBC-Pacific Bell's monopoly advantages for the benefit of PB Com violated state and federal competition requirements. By using in-bound calls to SBC-Pacific Bell local service customer service representatives and the associated CPNI data generated therefrom, PB Com sought to "maximize leverage of SBC-Pacific Bell's monopoly power as the state's primary local exchange carrier in order to acquire new customers for PB Com," in direct violation of §709.2 and implicit violation of the FCC's *Non-Accounting Safeguards Order*.[50] The ALJ's Proposed Decision expresses his finding that SBC-Pacific Bell, as a condition for receiving interLATA authority, should be required to establish a separate group of customer service representatives to perform joint marketing on behalf of PB Com.[51]

44. PB Com's marketing plan relied heavily upon SBC-Pacific's longstanding monopoly provider position.[52] The ALJ found that this position generates millions of incoming calls per year, since customers either "must or because of habit will continue to call SBC-Pacific Bell first when they want to inquire about their service, add new service, order new features, change their directory listing, or request a change in long distance carriers."[53] In his proposed decision, ALJ Walker cites specific marketing plans and scripts indicating that "Pacific Bell representatives will be expected to try to sell PB Com services on virtually all incoming calls, including those in which callers say that they have decided on AT&T, MCI or

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50. *1997 Proposed Decision*, at 36, 38.

51. *Id.*, at 39.

52. *Id.*, at 35.

53. *Id.*, at 36.

Sprint, for example, as their long distance carrier and simply wish to place a change order."[54] Evidence presented in the 1996 PB Com proceeding indicated that PB Com expected to attract 50% to 60% of new SBC-Pacific customers through aggressive marketing of SBC-Pacific contacts.[55] The ALJ found these aggressive marketing tactics to constitute anticompetitive behavior.[56]

45. FCC restrictions on the use of Customer Proprietary Network Information ("CPNI") require that an ILEC obtain explicit consent from a customer before it may utilize information in the customer's service record to market or sell competitive services to that customer. Consequently, as part of the routine customer contact during in-bound calls, SBC-Pacific Bell representatives would matter-of-factly ask the customer for his or her verbal permission to access the customer's records so that the representative could "talk to [the customer] about products that would be of use to [the customer] through PacBell Bell [sic] affiliates."[57] The SBC-Pacific representative would then use information regarding the customer's calling patterns to highlight a PB Com/PBLD long distance calling plan as the customer's best pricing option.[58] ALJ Walker found that using this data solely for the benefit of PB Com, at

54. *Id.*, at 35.

55. *Id.*

56. *Id.*, at 37.

57. *Id.*, at 35. It is my understanding that this process of obtaining the customer's consent to access the customer's CPNI has now been mechanized, and is performed by automated equipment before the customer is even connected to the Pacific Bell service representative.

58. *Id.*, at 37.

a time when callers have initiated call about other SBC-Pacific Bell services, "is also an abuse of market power and anticompetitive."[59]

46. The ALJ's conclusion that SBC-Pacific's plans for joint marketing and CPNI data use violated §709.2 remained consistent through both drafts of his Proposed Decision.[60] In fact, §709.2(c) of the Public Utilities Code requires, *inter alia*:

> (2) that there is no anticompetitive behavior by the local exchange telephone corporation, including unfair use of subscriber information or unfair use of customer contacts generated by the local exchange telephone corporation's provision of local exchange telephone service; and
>
> (4) that there is no substantial possibility of harm to the competitive intrastate interexchange telecommunications markets. (PU Code §709.2(c)(2) and (4)).

ALJ Walker was clear that he considered the joint marketing plans of SBC-Pacific and PB Com to violate this statute:

> There can be little question that this is the type of activity proscribed by the Costa Bill [the legislation enacting §709.2(c)]. Sales efforts of this nature on behalf of PB Com to virtually all SBC-Pacific Bell callers, regardless of the reason they are calling, constitutes "unfair use of customer contacts generated by the local exchange telephone corporation's provision of local exchange telephone service." By the same token, use of customer proprietary information maintained by SBC-Pacific Bell to encourage the sale of PB Com services over those of competitors is the type of marketing that the Legislature must have envisioned in urging us to determine that there is "no anticompetitive behavior

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59. *1998 Proposed Decision*, at 47.

60. *Id.*, at 56.

> by the local exchange telephone corporation including unfair use of subscriber information ...'"[61]

Importantly, the ALJ cited not only the discriminatory access to CPNI data, but also the context of marketing strategies using CPNI data. By using incoming calls and customer records, PB Com would have capitalized on "[t]he customer contacts and customer records ... garnered by SBC-Pacific Bell only through its decades of monopoly local exchange service."[62] Thus, two separate acts of anticompetitive behavior operating under SBC-Pacific Bell's joint marketing plan: First, there is PB Com's unique and preemptive access to a customer's CPNI data *at the very instant in time when that data is being created* (in the case of an in-bound order for new service) *or concurrently with an attempt to market the competitive long distance to a customer through a process that is entirely unavailable to nonaffiliated interexchange carriers*. Second, there is SBC-Pacific Bell's aggressive marketing on behalf of PB Com when contacted by customers regarding other matters.

47. SBC-Pacific had argued that if it complied with the FCC CPNI Order, there could be no unfair use of subscriber information or customer contacts. ALJ Walker found this argument unpersuasive.[63] The CPNI Order does not prohibit separate staff requirements regarding CPNI use, stating merely that decisions will be made on a case-by-case basis,

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61. *1997 Proposed Decision*, at 37.

62. *1998 Proposed Decision*, at 57.

63. *Id.*

considering actual state rules.[64] The text of the CPNI Order allows a variety of state rules regarding joint marketing and CPNI use. The ALJ cites the FCC's CPNI order stating that the rules governing CPNI use followed from evidence of anticompetitive procedures, not vice versa. ALJ Walker found that anticompetitive behavior can be defined separately from FCC mandates, and applicable rules may be modified or added to thwart such behavior. The FCC's CPNI order states that "[s]hould a record of CPNI misuse develop" under current orders, "we can and will revisit our conclusions." Judge Walker clearly applies this order directly to the PB Com situation: "The Commission in this proceeding developed such a record of intended 'CPNI misuse' during a lengthy and thorough hearing process." [65]

48. SBC-Pacific had also argued that, as to the tension between the joint marketing authority granted to ILECs in the *Non-Accounting Safeguards Order* and the competitive behavior requirements imposed by § 709.2(c), the California code was superseded. SBC-Pacific argued that, as long as it complied with the *Non-Accounting Safeguards Order*, it should receive unfettered rights to pursue joint marketing. ALJ Walker directly addressed this concern, recognizing that SBC-Pacific Bell customer service representatives would be able to directly market PB Com services after a three-year transition period. During the interim period, however, the ALJ determined that a separate sales staff would better serve competition in the telecommunications market in California.[66]

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64. *Id.*, at 58.

65. *Id.*, at 57.

66. *Id.*, at 56.

49. ALJ Walker expressed concern that SBC-Pacific Bell's joint marketing actually violated the equal access requirements of the FCC's *Non-Accounting Safeguards Order*.[67] Here, the FCC requires Bell operating companies to "inform new local exchange customers of their right to select the interLATA carrier of their choice and take the customer's order for the interLATA carrier the customer selects." ALJ Walker agreed with TURN that this equal access requirement is "empty" if SBC-Pacific Bell is allowed to use marketing scripts acknowledging that while numerous companies offer long distance service, the SBC-Pacific service representative can then immediately explain and sign up the caller for the long distance service offered by a SBC-Pacific Bell affiliate. The ALJ concluded that the PB Com marketing scripts were designed to focus the consumer's attention immediately upon PB Com and only PB Com. ALJ Walker concluded that "based on our reading of the FCC order, the FCC did not intend so artful a disregard of a Bell company's equal access requirement."[68]

50. Alternate draft decisions were released by Commissioners Duque in 1997 and Neeper in 1999, and the final order granting PB Com's CPCN was issued on February 4, 1999.[69] The final order deleted the ALJ's discussion and his proposed Findings of Fact and Conclusions of Law with respect to joint marketing and the use of CPNI, but significantly offered no alternative or contrary findings pertaining to these issues. Specifically, the final Decision is entirely silent with respect to the matter of SBC-Pacific Bell's or PB Com's

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67. *1997 Proposed Decision*, at 38.

68. *Id.*

69. D. 99-02-013.

compliance with §709.2(c). Instead, the decision merely concluded that the California and federal statutes pertaining to joint marketing were in conflict, and that the federal statute was controlling.[70]

51. I will defer to counsel the task of addressing the legal issue as to whether (a) there is in fact any inconsistency between the California and federal statutes with respect to this issue, and (b) whether the federal statute is properly controlling in the case of wholly *intrastate* services. Legal issues aside, a policy determination that §709.2(c) is superseded by *TA96* makes no sense and the matter demands to be revisited in light of numerous events that have taken place in the five-plus years since the federal statute was signed into law.

52. As a threshold matter, Section 271(d)(2)(B) expressly mandates the FCC to engage in consultation with state commissions prior to acting on a BOC's Section 271 application:

> Before making any determination under this subsection, the Commission shall consult with the State commission of any State that is the subject of the application in order to verify the compliance of the Bell operating company with the requirements of subsection [271](c).

In addition to addressing the Section 271(c)(2)(B) "competitive checklist," the state commission's consultative role (which embraces all of Section 271(c), not just the "checklist") also includes Section 271(c)(3)(C), which requires an affirmative finding that "the requested authorization is consistent with the public interest, convenience, and necessity."

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70. *Id.*, at Sec. 17.4.

Since certificates of "public convenience and necessity" are issued by state commissions, a state commission can certainly be *informed* by state statutes (such as §709.2(c)) even *and especially* if the state statute differs from — and perhaps even exceeds — the corresponding federal requirement. It would make no sense for Congress to expressly assign to the states a consultative role in the Section 271 process if the state commissions were confined solely to applying the *federal* statute.

53. Indeed, SBC-Pacific's notion that Section 271 supersedes §709.2(c) misses the point of the consultative process as contemplated in the federal *Act*. Even if as a legal matter the federal *Act* were controlling, nothing in the federal statute precludes a state commission from applying the directives of its state legislature in *advising* the FCC as to whether the public interest requirement has been satisfied. Moreover, and as I shall explain, the unfettered right claimed by SBC-Pacific Bell for it to engage in joint marketing of its own services and those to be offered by its long distance affiliate conflict with other provisions of the federal *Act* as well as with this Commission's own requirements with respect to a utility's relationships with its affiliates.

54. In fact, an analysis of TA96 and events arising therefrom can lead only to the conclusion that §709.2(c) actually *harmonizes with the federal statute and advances Congress' intent with respect to the 1996 federal legislation*. Section 271(e)(1) provides that "[u]ntil a Bell operating company is authorized pursuant to subsection (d) to provide interLATA services in an in-region State, *or until 36 months have passed since the date of enactment of*

the Telecommunications Act of 1996, whichever is earlier, a telecommunications carrier that serves greater than 5 percent of the Nation's presubscribed access lines may not jointly market in such State telephone exchange service obtained from such company pursuant to section 251(c)(4) with interLATA services offered by that telecommunications carrier." (Emphasis supplied.) The purpose of this provision was to limit the large IXCs' ability to offer "one stop shopping" of local and long distance service for up to three years or sooner if the BOC in a given state had obtained Section 271 interLATA authority, and thereby to protect the BOCs from IXC "one-stop shopping" type competition for up to three years. At the time of enactment in February 1996, there was a general expectation, both in Congress and in the telecommunications industry generally, that the new law would rapidly open local markets to competition and that such competition would develop quickly. The flood of new start-ups and the hundreds of billions of dollars of investment by non-ILEC firms certainly confirm this view. Congress clearly anticipated that the BOCs would fully and rapidly comply with Sections 251/252 and would quickly (i.e., within that three-year "protection" window) satisfy the Section 271(c)(2)(B) checklist, allowing them into the in-region interLATA long distance market *well before the three-year sunset date for the IXC joint marketing prohibition.*

55. In hindsight, of course, the three-year time frame contemplated by Section 271(e)(1) did not materialize, inasmuch as *not a single Bell Operating Company had complied with the Section 271(c)(2)(B) competitive checklist within the 36 months following enactment of the statute during which the large IXC joint marketing prohibition remained in effect.*

56. Had significant competition for basic local exchange telephone service actually materialized within the three-year time frame, consumers would have had a meaningful choice of local exchange service provider and, as such, the ALJ's finding that customers either "must or because of habit will continue to call SBC-Pacific Bell first when they want to inquire about their service, add new service, order new features, change their directory listing, or request a change in long distance carriers" would not have been the prevailing condition. If the local service market were competitive, customers could and would evaluate complete packages of local and long distance, basic and optional, voice and Internet access, services from a number of competing suppliers and would not be predisposed to call the incumbent LEC — SBC-Pacific Bell in this instance — first. Under those circumstances, entrants would be routinely engaging in joint marketing of local and long distance service, and ILEC opportunities to do the same would have been reasonable and appropriate.

57. But local competition did not develop as expected. Most customers don't have real choice as to their local carrier, and customers do call SBC-Pacific Bell first. Indeed, SBC-Pacific Bell's consumer market groups received **<<BEGIN PROPRIETARY END PROPRIETARY>>** in-bound calls (which do not include calls for repair services) during the year 2000, which works out to approximately **<<BEGIN PROPRIETARY END PROPRIETARY>>** calls per business day.[71] Most of these callers are likely not contacting SBC-Pacific for the purpose of ordering — or even inquiring about — SBC-

71. SBC-Pacific response to Working Assets data request 1-1.b. The per-day calculation assumes a 5-day work week.

Pacific's long distance services. Most are calling to order new or additional service, change their existing service, report a service problem, inquire about a billing issue, order optional features, or move their service to a new location. Each of these *in-bound* contacts provides SBC-Pacific with an *opportunity* to *sell* long distance service. And although initiated by the customer for a different purpose, each of these in-bound calls is, in the end, initiated by the caller with the intention of dealing in some manner with telephone service issues.

58. Contrast these in-bound calls that SBC-Pacific receives solely by virtue of its position as the dominant incumbent LEC to contacts that occur between competing long distance companies and their prospective customers. Some calls are in-bound as well, initiated by a prospective customer in response to a TV ad or a piece of direct mail, accomplished by the IXC at considerable cost and effort. Others arise through *outbound* telemarketing calls — like the ones that arrive during dinner when the vast majority of recipients just hang up the phone. Long distance carriers not affiliated with the incumbent LEC do not enjoy the benefit of being handed their customers on a **<<BEGIN PROPRIETARY END PROPRIETARY>>**-calls-a-day silver platter; they get their customer contacts only through considerable investment and effort.

59. A BOC's ability to engage in joint marketing of its own local services with its affiliate's long distance service is found in some rather back-handed language appearing at Sections 272(g)(2) and (3) of the federal *Act*:

> 272(g)(2): BELL OPERATING COMPANY SALES OF AFFILIATE SERVICES- A Bell operating company may not market or sell interLATA service provided by an affiliate required by this section within any of its in-region States until such company is authorized to provide interLATA services in such State under section 271(d).
>
> 272(g)(3): RULE OF CONSTRUCTION- The joint marketing and sale of services permitted under this subsection shall not be considered to violate the nondiscrimination provisions of subsection (c).

The "nondiscrimination provisions" being referred to here are found at subsection (c)(1) of Section 272:

> (c) NONDISCRIMINATION SAFEGUARDS- In its dealings with its affiliate described in subsection (a), a Bell operating company--
>
> (1) may not discriminate between that company or affiliate and any other entity in the provision or procurement of goods, services, facilities, and information, or in the establishment of standards.

But subsection 272(c)(2), which is *not* superseded by subsection 272(g)(3) and thus applies to joint marketing as well, states that a Bell operating company

> (2) shall account for all transactions with an affiliate described in subsection (a) in accordance with accounting principles designated or approved by the Commission.

Hence, the *Telecommunications Act* does not so much *permit* BOC joint marketing of its affiliate's long distance service, but rather does not expressly prohibit it by exempting the joint marketing activity from the nondiscrimination provision. In effect, the *Act* would appear to condone the very types of discriminatory treatment that the *California* statute seeks to prohibit.

60. It is also instructive, however, to look to other parts of Section 272 for guidance as to the extent to which such discriminatory behavior relative to joint marketing is actually contemplated by the federal legislation. Section 272(a) requires the establishment of a separate affiliate for the provision of in-region interLATA services, and section 272(f)(1) requires the continued existence of the interLATA affiliate for "3 years after the date such Bell operating company or any Bell operating company affiliate is authorized to provide interLATA telecommunications services under section 271(d), unless the Commission extends such 3-year period by rule or order." Section 272(b) defines the relationship between the BOC and its in-region interLATA affiliate:

> 272(b): STRUCTURAL AND TRANSACTIONAL REQUIREMENTS- The separate affiliate required by this section--
>
> (1) shall operate independently from the Bell operating company;
>
> (2) shall maintain books, records, and accounts in the manner prescribed by the Commission which shall be separate from the books, records, and accounts maintained by the Bell operating company of which it is an affiliate;
>
> (3) shall have separate officers, directors, and employees from the Bell operating company of which it is an affiliate;
>
> (4) may not obtain credit under any arrangement that would permit a creditor, upon default, to have recourse to the assets of the Bell operating company; and
>
> (5) shall conduct all transactions with the Bell operating company of which it is an affiliate on an arm's length basis with any such transactions reduced to writing and available for public inspection.

Nothing in subsection 272(g)(3) in any way exempts SBC-Pacific or its section 272(a) interLATA affiliate Pacific Bell Long Distance ("PBLD") from the requirements of section 272(b).

61. Significantly, §709.2(c) does not *prohibit* joint marketing; rather, it prohibits "*anticompetitive behavior* by the local exchange telephone corporation, including *unfair* use of subscriber information or *unfair* use of customer contacts generated by the local exchange telephone corporation's provision of local exchange telephone service" (emphasis supplied). Yet in arguing that the federal statute is controlling and that it actually *supersedes* the California law, SBC-Pacific is in effect suggesting that "anticompetitive behavior by the local exchange telephone corporation, including unfair use of subscriber information or unfair use of customer contacts generated by the local exchange telephone corporation's provision of local exchange telephone service" is now *permissible* under federal law. Such a contention, which follows directly from SBC-Pacific's argument, is nothing short of utter nonsense. Clearly, no purpose would be served by the Section 272(a) and (b) separate affiliate requirements if the types of concerns expressed in §709.2(c) and in ALJ Walker's *PB Com* Proposed Decision were without merit.

62. The CPUC's authority with respect to certification of PB Com was necessarily limited to its provision of *intrastate* long distance services, a power expressly reserved for the states in the 1934 *Communications Act.*[72] Indeed, Section 253 of the 1996 *Act*, which

72. 47 U.S.C. 152(b).

generally (Section 253(a)) prohibits a state commission from denying entry to a would-be competitor ("No State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service"), nevertheless expressly reserves to the states (Section 253(b)) the authority "to impose, on a competitively neutral basis and consistent with section 254, requirements necessary to preserve and advance universal service, protect the public safety and welfare, ensure the continued quality of telecommunications services, and safeguard the rights of consumers." §709.2(c) falls squarely within the scope of this authority.

63. Finally, courts have consistently held that the FCC may preempt a state commission with respect to matters involving the regulation of *intrastate* telecommunications service only where the actions of the state commission would interfere with or frustrate the federal policy or purpose. So, for example, in *North Carolina Utilities Commission v. FCC*,[73] the 4th Circuit Court held that actions by a state commission to prevent the use of customer-provided premises equipment ("CPE") in connection with *intrastate* services could be preempted by the FCC because there was no practical means for separating the use of the CPE between intrastate and interstate services, and the state commission's actions if allowed would thus have the effect of frustrating the FCC rule permitting the use of CPE for interstate services. On the other hand, the US Supreme Court, in *Louisiana PSC v. FCC*, upheld the state commissions' right to prescribe depreciation rates based upon different — and longer —

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73. *North Carolina Utilities Commission v. FCC*, 552 F.2d 1036 (4th Cir.) 1977.

economic lives of telephone plant for intrastate purposes than those established by the FCC for interstate purposes, because there was a *practical* means for accomplishing this accounting treatment.

> Moreover, we reject the intimation ... that the FCC cannot help but pre-empt state depreciation regulation of joint plant if it is to fulfill its statutory obligation and determine depreciation for plant used to provide interstate service, *i. e.*, that it makes no sense within the context of the Act to depreciate one piece of property two ways. The Communications Act not only establishes dual state and federal regulation of telephone service; it also recognizes that jurisdictional tensions may arise as a result of the fact that interstate and intrastate service are provided by a single integrated system. Thus, the Act itself establishes a process designed to resolve what is known as "jurisdictional separations" matters, by which process it may be determined what portion of an asset is employed to produce or deliver interstate as opposed to intrastate service. 47 U. S. C. § § 221(c), 410(c). ... As respondents concede, and as the Court of Appeals itself acknowledged, 737 F.2d, at 396, it is certainly possible to apply different rates and methods of depreciation to plant once the correct allocation between interstate and intrastate use has been made ... Respondents maintain that if the FCC and the States apply different depreciation practices to the same property, then the "whole purpose of depreciation, which is to match depreciation charges of the equipment with the revenues generated by its use," will be frustrated. But this is true and a concern only to the degree that the principles, judgments, and considerations that underlie depreciation rules reflect only "real world" facts, rather than choices made by regulators partially on the basis of fact and partially on the basis of such factors as the perceived need to improve the industry's cash flow, spur investment, subsidize one class of customer, or any other policy factor. What is really troubling respondents, of course, is their sense that state regulators will not allow them sufficient revenues. While we do not deprecate this concern, §152(b) precludes both the FCC and this Court from providing the relief sought. As we so often admonish, only Congress can rewrite this statute.[74]

74. *Louisiana PSC v. FCC*, 476 U.S. 355 (1986).

64. Actions by the California legislature to prohibit certain anticompetitive practices with respect to *intrastate* services that flow from joint marketing would not preclude the FCC from authorizing SBC-Pacific Bell's entry into the *interstate* in-region long distance market or permitting SBC-Pacific to engage in joint marketing of local and *interstate* long distance services. Mechanically, this could be readily accomplished by separating "intrastate interLATA calling" and "interstate interLATA calling" into separate "PIC" choices, in addition to the separate "intraLATA services" PIC choice that already is available to customers. Single-LATA states are already permitting customers to choose separate intrastate and interstate PICs. And if existing switch software may not at the present time support a three-PIC structure, there is no conceptual reason why this cannot be accomplished and accommodated any more than there was no reason, as determined by the Supreme Court, that separate intrastate and interstate books of account could be maintained for purposes of supporting different jurisdictional depreciation rates and practices. Indeed, when "equal access" was first introduced, only interLATA calls were subject to the customer's choice of PIC, and all intraLATA calls were presumptively routed to the ILEC unless the customer dialed a 10XXX carrier selection access code on a call-by-call basis. Among other things, ILECs resisted efforts to introduce an intraLATA PIC choice on the grounds that switch software extant at the time did not support two separate PICs. This limitation was, of course, eventually overcome and was never a basis for rejecting intraLATA equal access.

65. In any event, even if the Commission, in adopting the final *PB Com* decision, had *expected* that the federal statute and the FCC's *Non-Accounting Safeguards Order* would

address the concerns of the California legislature when it enacted §709.2(c), a number of conditions have arisen since the *PB Com* decision was issued in 1999 that now require that those original expectations be revisited at this time.

66. First, The FCC has issued several rulings[75] since this Commission issued its *PB Com* decision that have worked to diminish the effectiveness of the *Non-Accounting Safeguards Order* and in so doing to afford BOCs, once having been granted authority pursuant to Section 271(c) to offer in-region interLATA long distance service in any state, the ability and opportunity to market and to sell their long distance service to the BOC's *local* service customers *at the time that the local service customer initiates an order for local exchange service*, effectively *preempting* competing long distance service providers from addressing that customer until *after* his or her initial selection of the BOC as the Presubscribed Interexchange Carrier ("PIC"). §709.2(c)(2) expressly prohibits such practices in California.

67. Where a customer is not presently a BOC local service subscriber (which is the case when, for example, a customer initiates a call to a BOC to order new local telephone service for his or her home or business), the FCC permits BOCs (after having received interLATA

75. *BA-NY Section 271 Order*; *BellSouth South Carolina Section 271 Order*"); *Second BellSouth Louisiana Section 271 Order*"); *In the Matter of AT&T Corp., Complainant, v. New York Telephone Company, D/B/A Bell Atlantic-New York, Defendant*, Memorandum Opinion and Order, File No. EB-00-MD-011, FCC 00-326, released October 6, 2000 ("*AT&T/BA-NY Order*").

authority) to expressly "recommend" the BOC affiliate's long distance service as long as the BOC service representative also and contemporaneously offers to read the customer a list of available non-BOC long distance carriers whose services are also available in the customer's area. Where the customer is *already* a BOC local service subscriber and contacts the BOC, for example, to order an additional access line or some other change in the customer's service, the FCC has permitted the BOC to specifically offer and sell its long distance service to that customer *without having to also offer to read the list of other long distance service providers.*[76]

68. The FCC thus permits BOCs to afford their long distance affiliate preferential treatment vis-a-vis non-affiliated IXCs during telemarketing contacts *initiated by customers* made for the purposes of ordering *local* telephone service or engaging in some other local service transaction. In its *Order* in CC Docket No. 97-208 denying BellSouth's Application to provide interLATA services in South Carolina, the FCC explained its rationale for this provision:

> ... We agree with BellSouth and Ameritech that a BOC, during an inbound telephone call, should be allowed to recommend its own long distance affiliate, as long as it contemporaneously states that other carriers also provide long distance service and offers to read a list of all available interexchange carriers in random order. In the *Non-Accounting Safeguards Order*, the Commission stated that the BOCs' existing obligation to provide any customer who orders new local exchange service with the names and, if requested, the telephone numbers of all of the carriers offering interexchange services in its service area in random order was not incompatible with the BOCs' right to joint market. The Commission

76. *AT&T/BA-NY Order*, at para. 6.

> concluded that a BOC could market its affiliate's long distance services to inbound callers as long as the BOC also informed those customers of their right to select the interexchange carrier of their choice and provided the names and numbers of all interexchange carriers in random order. Thus, the *Non-Accounting Safeguards Order* sought to balance a BOC's continuing equal access obligations pursuant to section 251(g) with the right of a BOC and its affiliate to market services jointly under section 272(g).[77]
>
> In considering the issue of whether BellSouth's marketing script meets the requirements of sections 251(g) and 272(g), we find that the Commission's decision in the *Ameritech Michigan Order* placed too much weight on the equal access obligations, and too little weight on the BOCs' right to jointly market local and long distance services. We note that the equal access obligations requiring BOCs to provide the names and telephone numbers of interexchange carriers in random order were written at a time when BOCs could not provide (and therefore could not market) long distance service. Now that BOCs, upon authorization to provide in-region, interLATA services, are permitted under the Act to market their services jointly, we must harmonize the existing equal access requirements with their right under the Act to engage in joint marketing.[78]

This Commission's *PB Com* decision was also "written at a time when BOCs could not provide (and therefore could not market) long distance service," and so the Commission looked to the then-existing FCC rule, as set forth in the *Non-Accounting Safeguards Order*, which held "that the BOCs' existing obligation to provide any customer who orders new local exchange service with the names and, if requested, the telephone numbers of all of the carriers offering interexchange services in its service area in random order was not incompatible with the BOCs' right to joint market. The Commission concluded that a BOC could market its affiliate's long distance services to inbound callers as long as the BOC also

77. *BellSouth South Carolina Section 271 Order*, 13 FCC Rcd 1, 670-672, para. 237, footnotes omitted.

78. *Id.*, para. 238, footnotes omitted.

informed those customers of their right to select the interexchange carrier of their choice and provided the names and numbers of all interexchange carriers in random order." But the FCC has since changed its view, and in a manner that runs expressly counter to §709.2(c)(2): "[A] BOC, during an inbound telephone call, should be allowed to recommend its own long distance affiliate, as long as it contemporaneously states that other carriers also provide long distance service and offers to read a list of all available interexchange carriers in random order."

69. Thus, although *other* long distance service providers must be identified *in random order* (so as, presumably, not to unduly benefit a carrier that would be listed first if read in, for example, alphabetical order, and not unduly harm those carriers that might otherwise always be far down the list), the BOC may now specifically *recommend*, before it volunteers the names of *any other* interexchange carrier, its own affiliate's long distance service. The Commission explained:

> We thus conclude that, even if a BOC's inbound marketing script markets the services of its long distance affiliate, the script is acceptable as long as the BOC contemporaneously fulfills the equal access requirements described in the *Non-Accounting Safeguards Order*, *i.e.*, offers to read, in random order, the names and, if requested, the telephone numbers of all available interexchange carriers.[79]

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79. *Id.*, para. 239.

70. While the FCC's *BellSouth South Carolina Section 271 Order* seemingly contemplates the BOC's *contemporaneous* recitation of available interexchange carriers along with its "recommendation" of its own affiliate's long distance service, in practical terms one of these two events must necessarily precede the other, and so the literal "contemporaneous[] fulfill[ment of] the equal access requirements" is a physical impossibility. And in fact, SBC-Pacific will be permitted to (and from my review of the SBC-Pacific marketing scripts provided in response to Working Assets data request 1-1.a) and intends to **<<BEGIN PROPRIETARY**

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71. It would be difficult for anyone to seriously contend that the BOC's ability to separately *and preemptively* identify *and recommend* its own affiliate's long distance service does not afford it a substantial advantage over its long distance rivals in being the first to offer and to sign up a new local service customer for its long distance offering. The FCC itself has obviously recognized the advantage to an IXC of appearing early (or even first) on the list of service providers by its *express requirement*, as set forth in the *Non-Accounting Safeguards Order*, that the names of IXCs be read *in random order*.[80] The practical effect of the physical impossibility of simultaneously making the BOC affiliate recommendation

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80. *In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended, First Report and Order*, 11 FCC Rcd 21905, 22046 para. 292 (1996)(*Non-Accounting Safeguards Order*), citing In the Matter of Investigation of Access and Divestiture Related Tariffs, Allocation Plans Waivers and Tariffs, *Memorandum Opinion and Order*, 101 FCC 2d (1985) at 950.

while contemporaneously reading the full list of available IXCs, together with the BOC's right to make its "recommendation" *prior to identifying any alternative long distance providers*, affords it an enormous marketing advantage in selling long distance services. As I have previously noted[81] and as the CSFB report observes, this preemptive use of the "inbound channel" by both Verizon and SBC to "sell" their long distance service to *new* local service customers has been the principal explanation for their extraordinary success in acquiring customers in the first year in which they have been permitted into the long distance business. Indeed, SBC has apparently been sufficiently satisfied with its market performance that it has recently elected to *increase* its interstate long distance rates in Texas.[82]

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81. *Supra*, para. 5.

82. "SW Bell raises interstate rate; current subscribers unaffected; PUC approval not needed," *Ft. Worth Star-Telegram*, February 2, 2001:

> Southwestern Bell announced it was raising the interstate rate on its flagship plan from 9 cents a minute to 10 cents a minute for new customers seven months after entering the long-distance market in Texas. Current subscribers will see no change in their domestic U.S. calling charges, said Shawn Ramsey, a San Antonio-based spokeswoman for Southwestern Bell, a unit of SBC Communications.
>
> Ramsey defended the increase, which doesn't require approval by the state's Public Utility Commission, by saying the plan is superior to many offered by the major long-distance services. "We beat the pants off of them," she said. "We've got great rates any way you slice or dice it." Asked if the higher rate reflects a need to boost profits, she said: "We've been in the market about eight months now. We've learned a lot and made a number of changes that reflect what we've seen. And we've changed our plan accordingly."

72. There are, in fact, a number of reasons why a customer might initiate a contact with a LEC and, to the extent that the BOC continues to enjoy overwhelming market dominance, most such contacts will inevitably be with the BOC in areas in which the BOC offers local exchange service as an ILEC. Contacts initiated by customers would take place where the customer needs to place an order for new telephone service, for an additional access line, or to add or change service features. Customers may also initiate contacts for bill inquiries, repair service, or to obtain information about new services that might become available such as, for example, ADSL.

73. In its Order denying AT&T's *Complaint Alleging Improper Marketing by Bell Atlantic in the New York Long Distance Market*, the FCC modified, and in fact *relaxed*, the requirement (per its *South Carolina* order) that BOCs must contemporaneously offer to read a list of (non-affiliated) long distance carriers to the customer. The FCC ruled that "Bell Atlantic is not obligated, when marketing [Bell Atlantic Communications, Inc.'s] services, to inform existing customers calling to request an additional line that they have a choice of long distance carriers and to offer to read a list of available carriers. That obligation applies only to customers who either (1) receive service from Bell Atlantic for the first time, or (2) move to another location within Bell Atlantic's area."[83] Thus, where the customer *already has a local service relationship with a BOC*, the BOC is *not required* to offer to read the list of IXCs; it may limit the discussion entirely to the BOC's own long distance service. And, even where the customer is contacting the BOC for the purpose of ordering, for example, an

83. *AT&T/BA-NY Order*, at para. 15.

additional access line, the BOC may use the contact to sell the customer its long distance service *on the customer's primary access line.*

74. Indeed, at least with respect to these types of sales at the time of the initial local service contact, the BOC need spend little if any resources actually advertising or otherwise marketing its long distance services. The inbound caller has already made the contact with "the phone company" for basic telephone service and, unless that customer is a student of telecommunications industrial organization and regulation, he or she is as likely as not to accept the BOC's "recommendation" as the only and obvious choice. That selling long distance services to "inbound" *local* service customers is *the* centerpiece of SBC-Pacific's long distance marketing strategy is confirmed by its *current* marketing scripts and training materials, which may be even more aggressive with respect to exploitation of the in-bound local service order channel than had been evident from the materials that were examined by ALJ Walker and upon which his proposed decision was based.

75. I have reviewed the PBLD marketing scripts and training materials that were produced by SBC-Pacific in response to Working Assets data request 1-1.a. These are provided as Attachment 3 to my Declaration. The scripts and training materials show that SBC's intention to capitalize on the affiliate relationship between Pacific Bell and Pacific Bell Long Distance arises in three distinct ways:

(1) By its use of “Pacific Bell” in the names of its pricing plans and by designing product tie-ins between PBLD and Pacific Bell local services, SBC-Pacific attempts to blur the distinction between Pacific and PBLD in the minds of its customers.

(2) SBC uses the PBLD affiliate is a vehicle for shifting customers and revenues away from the regulated Pacific Bell ILEC and over to the nonregulated PBLD. This is achieved by **<<BEGIN PROPRIETARY**

END PROPRIETARY>> In addition to producing obvious financial harm to Pacific Bell, which I discuss in more detail below, the **<<BEGIN PROPRIETARY**

END PROPRIETARY>>

(3) Because the process by which Pacific Bell’s costs of selling PBLD services will fall woefully short of capturing the full value to PBLD of these Pacific Bell activities, the effect will be to force customers of Pacific Bell to cross-subsidize the competitive long distance services being offered by PBLD.

76. It is highly unlikely that anyone merely listening to the oral explanations of the various service options being offered by the Pacific Bell representative, and seeing the written words themselves, will recognize or understand the distinction between "Pacific Bell" and "Pacific Bell Long Distance." Despite warning boxes advising representatives **<<BEGIN PROPRIETARY** **END PROPRIETARY>>**,[84] training scripts appear to be specifically designed to capitalize on this confusion. For example, the price plan that Pacific Bell expects to be most popular with its residential customers is called the **<<BEGIN PROPRIETARY** **END PROPRIETARY>>** When this plan is described to customers over the phone by the representative, it is likely that most, if not all, customers will assume that what is being described is a "Pacific Bell" long distance plan (i.e., "long distance" as a service, rather than "Long Distance" as part of the corporate name). Without the benefit of the capital "L" and capital "D," it will be virtually impossible for a customer to differentiate between the idea that the regulated utility is offering long distance service, and the reality that an unregulated affiliate is offering this service. PBLD then exploits this confusion by directing Pacific Bell representatives to **<<BEGIN PROPRIETARY** **END PROPRIETARY>>**[85] Pacific Bell Long Distance here ignores or obfuscates the fact that part of the customer's telecommunications

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84. SBC-Pacific response to Working Assets data request 1-1.a, PBCL 012010.

85. SBC-Pacific response to Working Assets data request 1-1.a, PBCL 011926.

services are being provided by Pacific Bell, or that the "same bill" feature will apply whether the LPIC stays with Pacific Bell or is transferred to PBLD.

77. Beyond the naming of its various service plans, however, specific marketing techniques appear designed to feed into this confusion. Representatives are given a script indicating that the long distance plan that they should first try to sell to a customer is the **<<BEGIN PROPRIETARY**

END PROPRIETARY>>[87]

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86. Although this script is meant to come after a new connect customer has signed up for his or her local service, it is unlikely the representatives will, in practice follow this ordering. Since "Simple Solutions" is a local bundle (which representatives most likely get an incentive to sell), it is unlikely that any and all mention of the favorable long distance rate plan they will receive will remain unmentioned until the "long distance portion" of the call.

87. SBC-Pacific response to Working Assets data request 1-1.a, PBCL 011942.

Were the customer already confused about who offered the specific long distance service, this tie-in gives them good reason to believe that Pacific Bell is providing both the enhanced services and long distance.

78. Pacific Bell Long Distance training materials encourage Pacific Bell representatives to **<<BEGIN PROPRIETARY**

END PROPRIETARY>> to the financial detriment of Pacific Bell and in many cases of the ratepayer as well.[88] Since intraLATA calls handled by Pacific Bell and Pacific Bell Long Distance would both be billed on a single bill in any event, there is nothing that particularly distinguishes Pacific Bell Long Distance intraLATA service from that of Pacific Bell except for the rate plans offered. However, representatives are instructed **<<BEGIN PROPRIETARY**

88. SBC-Pacific response to Working Assets data request 1-1.a, PBCL 011928.

END PROPRIETARY>>[89]

79. After first ensuring that customers are not **<<BEGIN PROPRIETARY**

END PROPRIETARY>>

80. Based on rates published on the Pacific Bell website for intraLATA service and the PBLD rates that Pacific Bell representatives are being trained on in the PBLD training materials, **<<BEGIN PROPRIETARY**

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89. Pbcl 011926. **<<BEGIN PROPRIETARY**

END PROPRIETARY>>

90. SBC-Pacific response to Working Assets data request 1-1.a, PBCL 012003.

91. *Id.*

END PROPRIETARY>>

81. The PBLD marketing scripts and training materials serve to underscore and confirm the inescapable conclusion that the specific "joint marketing" arrangement that SBC-Pacific contemplates as between Pacific Bell and Pacific Bell Long Distance will constitute "unfair use of subscriber information or unfair use of customer contacts generated by the local exchange telephone corporation's provision of local exchange telephone service" as expressly prohibited by §709.2(c)(2). Not only is such use "unfair" with respect to SBC-Pacific's long distance competitors, it is even "unfair" in its treatment of Pacific Bell *customers*, because it is specifically intended to confuse them and to induce them to make incorrect choices in their selection of service provider.

The nature of the financial relationship between the regulated SBC-Pacific Bell and its long distance affiliate PBLD violates §709.2(c)(3), this Commission's "ratepayer indifference" standard and other affiliate transaction regulations, as well as Sections 272(b)(1), (3) and (5) and 254(k) of the federal *Telecommunications Act of 1996*.

82. Section 709.2(c)(3) requires the Commission to "[d]etermine[] that there is no improper cross-subsidization of intrastate interexchange telecommunications service by

requiring separate accounting records to allocate costs for the provision of intrastate interexchange telecommunications service and examining the methodology of allocating those costs." Prohibitions against cross-subsidization are also found in the federal law. Section 254(k) provides that

> A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

Section 272(b)(5) requires that the in-region interLATA affiliate

> shall conduct all transactions with the Bell operating company of which it is an affiliate on an arm's length basis with any such transactions reduced to writing and available for public inspection.

And this Commission has, on a number of occasions, taken steps to prevent self-dealing between SBC-Pacific and any affiliate that would operate to cross-subsidize that affiliate's activities.

83. At D.87-12-67, the Commission reiterated its bedrock principles regarding the relationships between a utility and its affiliates:

> ... Before addressing the merits of this particular case, we think it is appropriate to state certain fundamental principles that we will use regarding affiliate issues. (PU Code Section 851 et. seq.)
>
> First, we are determined to make the ratepayer indifferent to the formation of a holding company type of organization as well as to the operations of any affiliates or subsidiaries. Our objective is to provide the mechanisms that will ensure this ratepayer indifference. It therefore follows that a utility and its ratepayers must be compensated for any flow of actual resources or benefits to an affiliate. We believe this is our unquestioned continuing responsibility.
>
> Second, we will judge each utility individually as to its relationship to a holding company or to affiliates. While the general principle of ratepayer indifference is common across utilities, the specific facts may merit some differences in treatment from utility to utility. Given the complexity of utility-affiliate transactions, we are committed to assuring that ratepayer indifference will in fact occur.[92]

Applying these principles with respect to the pricing of services, both tangible and intangible, that are provided by the utility to its affiliate, the Commission stated:

> Our basic transfer pricing [*138] theory has been to charge the affiliate the higher of cost or market value for transferred services. In this way, we protect ratepayers by assuring that the utility treats an affiliate just as it would any other unaffiliated firm; that is, charge what the market will bear, but decline the transaction if the market will not pay at least the cost of providing the transferred service.
>
> Intangible benefits as defined by this decision are provided at no direct cost to the utility. However, there are other benefits (like technical information) that may be costless to provide yet valuable to receive. We question why a market pricing standard can be used for other costless services, but not for "intangibles."

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92. D.87-12-067, 27 CPUC2d 1, 136.

> ... We are persuaded that intangible "benefits" of any appreciable magnitude can be identified and priced by an appropriate market pricing standard. ...[93]

84. The general principles adopted in D.87-12-067 were applied to the specific fact set pertaining to that case (A.85-01-034) and resulted in the imposition of transfer pricing requirements with respect to the transfer of certain intangible benefits from Pacific Bell to its affiliates. Specifically, the Commission adopted a 13% "referral fee" to be applied to the entire revenue resulting from the sale of service by an affiliate resulting from a "referral" by a Pacific Bell sales or service representative,[94] and a 25% "employee transfer fee" to be applied against the annual salary of any Pacific Bell employee that is transferred to the affiliate.[95] In its *Pacific Bell Information Services* ("PBIS") decision, D. 92-07-072, the Commission, based upon the specific facts of that case, retained the 25% employee transfer fee but required that the 13% "referral" fee be applied against only the first month's revenues arising from the sale of the affiliate's services.[96] In D.87-12-067, the Commission rejected recommendations by DRA and other parties for a 5% "royalty fee" to be paid by the affiliate to Pacific Bell for the use of the Pacific Bell name, not as a matter of principle but rather because "[a]s to *the facts of this case* and based on the foregoing principles, we simply are

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93. *Id.*

94. *Id.*, at 137.

95. *Id.*

96. D.92-07-072, 45 CPUC2d 109, 135.

not persuaded that DRA's recommendation for a 5 percent across-the-board royalty should be adopted."[97] However, in its 1986 ruling authorizing the creation of a holding company for SDG&E, the Commission adopted a set of specific conditions that, if present, would justify the imposition of a royalty payment by the affiliate to the utility:

> We recognize that some affiliates may receive more benefits or impose more costs than others because of the nature of their business or the extent of their contact with SDG&E. Recognizing these variations and the difficulty in quantifying the benefits and costs involved, we seek through these hearings to develop a system of payment benchmarks. Along with other factors, these benchmarks would take into account the extent to which the affiliate enterprise is related to the regulated activities of the utility. The development of such benchmarks would also recognize the possibility of no affiliate payment being made if in fact there are no cost or benefit consequences adverse to the utility. Once established we contemplate that the benchmarks will be subject to review and modification on a case-by-case basis, upon petition by the SDO affiliate or the Commission staff. In response to a petition to determine the level and basis for an affiliate payment, the Commission shall give particular consideration to the following:
>
> - the business plans and organizational structure of the affiliate and its effect on the diversion of management attention;
>
> - the effects of utility name and reputation on the affiliate business;
>
> - whether cross-subsidies are likely to occur due the nature of the affiliate's businesses and the likelihood of intercompany transfers;
>
> - the ability of the affiliate to utilize proprietary information, utility assets and expertise;
>
> - the ability to measure a transaction's value by market tests or market proxies;

97. D.87-12-067, 27 CPUC2d 1, 136, emphasis supplied.

- the level of risk involved in the development and marketing of a new product or service.[98]

There can be no question but that all of the conditions identified by the Commission as a basis for imposing a royalty payment apply with respect to the relationship that SBC-Pacific contemplates between the ILEC and the PBLD entities.

85. In the present case, SBC-Pacific has been extraordinarily selective in its reading of the Commission's affiliate transaction decisions and in its interpretation and application of state and federal statutes prohibiting cross-subsidization and self-dealing. According to SBC-Pacific's response to Working Assets data request 1-1.e, the basis for transfer payments for services furnished by Pacific Bell to PBLD are those provided in three CPUC rulings, D.86-01-026, D.87-12-067, and D.92-07-072, and in the FCC rules adopted in CC Docket 96-150. By its reference to these rulings as the *sole basis* for its planned transfer payments, SBC-Pacific is implicitly asserting that the facts applicable to those three matters are substantially the same as those pertaining to the PBLD/Pacific Bell relationship. SBC-Pacific offers no evidence whatsoever to support such a contention, nor could it, because the facts surrounding the planned PBLD/Pacific Bell relationship do not even remotely resemble those addressed by the Commission in the three cited decisions.

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98. *Re San Diego Gas and Electric Company, Order Authorizing a Combination Gas and Electric Utility to Reorganize to Become a Subsidiary of a Largely Diversified Holding Company*, A.85-06-003, D.86-03-090, 20 CPUC2d 660, 684.

86. As I have previously noted, SBC-Pacific's training materials state that **<<BEGIN PROPRIETARY**

END PROPRIETARY>>[99] Thus, the personnel that sell PBLD services are employees of Pacific Bell, not PBLD. They are not "transferred" to PBLD, and hence PBLD pays no "employee transfer fee" to Pacific Bell for such personnel. In accounting materials provided with the Declaration of Mr. Robert Henrichs, SBC-Pacific makes clear its approach to establishing the transfer payment for PBLD's use of Pacific Bell employees: The payment will be based upon the loaded labor cost for the (claimed) average time spent by the Pacific Bell representative specifically with respect to the discussion of PBLD services, plus 10%, but the payment will apply only in those cases where the activity results in an actual sale of PBLD services to the Pacific Bell customer.[100] The "cost-plus-10%" approach was adopted by the Commission in D.87-12-067 as a surrogate for assessing the market value of the services furnished by Pacific Bell to an affiliate based upon the facts before the Commission in that case.[101] Incredibly, while purporting to calculate "value" based upon the "cost" to Pacific Bell plus a nominal mark-up, the process devised by SBC-Pacific for this transfer price affords *no compensation whatsoever* for services provided to

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99. SBC-Pacific response to Working Assets data request 1-1.a, Web-based Training 1, Sec. 6, screen 3 of 4.

100. Henrichs (SBC-Pacific), Attachment A, Schedule 510, dated 4/17/00.

101. D.87-12-067, 27 CPUC2d 1, 136.

PBLD *that do not result in a sale of PBLD services.* The result of this compensation scheme is a payment by PBLD to Pacific Bell of $1.39 for each "PIC" to PBLD.[102]

87. The actual time spent by a Pacific Bell service representative in selling PBLD service was, according to Mr. Henrichs' Schedule 510, based upon a "study."[103] The average time that was found to have been required for this transaction is given as 66.51 seconds. There appears to have been no attempt to allocate to the PBLD "sale" any time spent with the customer to acquire customer information ("CPNI") or to obtain permission to use that CPNI in the PBLD sales transaction, nor is any time allocated for sales representative discussions with customers that did not result in a sale of PBLD service. An examination of the training materials and marketing scripts indicates that there is no possibility that all of the discussions being called for could possibly be completed within the 66.51 seconds that were identified in the "study." For example, **<<BEGIN PROPRIETARY**

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102. SBC-Pacific's response to Working Assets data request 1-6.a indicates a payment amount of $3.54 for each successful sale of PBLD services. I am not able to reconcile this response with the $1.39 figure included in Mr. Henrichs' accounting documents, Attachment A, Schedule 510.

103. Henrichs (SBC-Pacific), Attachment A, Schedule 510.

104. SBC-Pacific response to Working Assets data request 1-1.a, PBCL 011981.
<<BEGIN PROPRIETARY

(continued...)

END PROPRIETARY>>.[105] **<<BEGIN PROPRIETARY**

END PROPRIETARY>>.[106] The marketing script also directs the sales representative to **<<BEGIN PROPRIETARY**

END PROPRIETARY>>.[107]

88. Although it is difficult to simulate actual sales situations, I have attempted to estimate the amount of time it would require for a sales representative to go through all of the points and statements that are set out on the various marketing scripts by reading through them aloud with an associate playing the role of the customer. Speaking at a normal pace and assuming a reasonable amount of customer interaction, I estimate that the time required

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104. (...continued)

END PROPRIETARY>>

105. SBC-Pacific response to Working Assets data request 1-1.a, Web-based Training 1, Sec. 2, screen 11 of 20.

106. *Id.*, PBCL 011942, 011943.

107. *Id.*, PBCL 011928.

for a Pacific Bell sales representative to go through the full script would be at least four minutes, and even longer if multiple rate plans and international plans are discussed.

89. In addition to the explicit payment for the sales representative's time, PBLD will pay a 13% "referral fee" for each successful sale.[108] SBC-Pacific does not state whether this is to be calculated with respect to *all revenue* to PBLD arising from the sale, or limited solely to the first month's revenue. However, inasmuch as the *PBIS* decision, which allowed the "referral fee" to be based upon only the first month's revenue, was one of the three CPUC rulings expressly cited by SBC-Pacific as the basis for its transfer payments to Pacific Bell, it is reasonable to assume that the Company intends to limit the "referral fee" to that amount. According to the FCC's *Trends in Telephone Service* report for 2000, the average long distance revenue generated by residential customers is \$19 per month[109]; assuming that this is representative of conditions in California, it would translate into a "referral fee" of only about \$2.47 for each successful sale, bringing the total transfer payment to something in the range of \$4 to \$6.

90. Customer acquisition is among the most costly aspects of an interexchange carrier's operation. Without the benefit of the embedded ubiquitous customer base that is uniquely available to PBLD, other IXCs must pursue active marketing strategies involving extensive

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108. SBC-Pacific response to Working Assets data request 1-6.a.

109. FCC Industry Analysis Division, Common Carrier Bureau, *Trends in Telephone Service*, August 2001, at Table 3.2.

media advertising, telemarketing, direct mail, and special promotions (cash, airline miles, etc.). When spread over the number of sales that are actually consummated, these costs can amount to hundreds of dollars per customer acquired. I am aware of at least one analysis that has put such cost at "up to $300 to $600 in sales support, marketing and commissions" per customer acquired.[110]

91. There is nothing "speculative" about the enormous and unique value of the "services" that are provided by Pacific Bell to PBLD; indeed, they represent virtually the *totality* of PBLD's entire sales and marketing operation. The value of the "in-bound channel" to SBC's long distance business in Texas has been recognized by securities analysts[111] and has been graphically demonstrated by the recent moves by SBC in Texas to *increase* its interLATA long distance rates.

> SBC Communications, Inc., offered evidence today that increases in long distance rates don't necessarily dampen demand, especially if long distance is part of a service bundle. SBC tested that theory in Oklahoma and Kansas after it won FCC permission to offer interLATA services in those states, said Randall Stephenson, the company's senior vice president–finance.
>
> "We entered Oklahoma and Kansas in the March time frame with a higher price point than we entered Texas with [in July 2000], and we're seeing penetration

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110. See Borna, Claude, "Combating Customer Churn," in *Business and Management Practices,* Vol. 11, No. 3; Pg. 83-85; ISSN: 0278-4831, Horizon House Publications, Inc., Telecommunications Americas Edition (March, 2000).

111. CSFB report, *supra*, footnote 1.

> rates very comparable to what we saw in Texas," he said. "That product seems to sustain the price increase very well."[112]

Clearly, PBLD will be able to derive measurable monetary value, in the form of higher prices for its long distance services, when that "long distance is part of a bundle." The value to PBLD of these "intangible benefits" arising from its access to Pacific Bell employees, customers, and corporate identify "can be identified and priced by an appropriate market pricing standard," as the Commission had required in D.87-12-067 as a condition for setting a transfer price for transfers of intangibles from the utility to an affiliate.

92. Any payment by PBLD that falls short of the *industry* cost of customer acquisition is an express violation of this Commission's requirement that Pacific Bell "charge the affiliate the higher of cost or market value for transferred services."

93. The "ratepayer indifference" standard is also being blatantly violated by the training materials' and marketing scripts' directive that **<<BEGIN PROPRIETARY**

END PROPRIETARY>> There can be nothing "arm's length" about this type of relationship: No rational business would **<<BEGIN**

112. *TR Daily*, July 25, 2001.

PROPRIETARY **, END PROPRIETARY>>** *yet that is precisely and unambiguously what Pacific Bell is directed its employees to do with respect to* **<<BEGIN PROPRIETARY** **END PROPRIETARY>>**[113]

94. The Commission has long recognized the potential for a utility to engage in practices and transactions with an affiliate that would work to undermine the financial integrity of the utility for the benefit of the parent corporation's shareholders. Citing an earlier observation made with respect to SDG&E in its Pacific Bell D.87-12-067 decision, the Commission noted:

> In our prior SDG&E holding company decision we expressed our concerns on the subject as follows:
>
> > "Whatever pressures may be operating upon management to [pursue] diversification, we cannot permit the process of diversification to become a vehicle for eroding the cost-effective investment base of the utility. We must assume that top management as well as the Commission has a strong interest in fully weighing the impact of affiliate ventures on the utility and specifically on its capacity to serve the public ..."
>
> No one should question the need to preserve the strength and vitality of the regulated utility.[114]

Unfortunately, the Commission's faith in "top management" to assure that affiliate relationships do not "become a vehicle for eroding the cost-effective investment base of the

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113. SBC-Pacific response to Working Assets data request 1-1.a, PBCL 011926.

114. D.87-12-067, 27 CPUC2d 1, 137.

utility" seems to have been misplaced with respect to SBC-Pacific, since that is precisely what will result from a policy of deliberately shifting customers and revenue away from Pacific Bell and over to PBLD.

95. SBC-Pacific is not proposing that PBLD pay any "royalty" to Pacific Bell for its use of the "Pacific Bell" name, apparently ignoring the requirement for such a payment that was adopted in the SDG&E holding company decision. As I have previously noted, the marketing scripts and training materials reveal a concerted and deliberate effort not just to capitalize on customer familiarity with the Pacific Bell name, but actually to *confuse* customers as to which entity ("Pacific Bell" vs. "Pacific Bell Long Distance") is actually providing the service. Indeed, Pacific Bell sales representative are expressly directed *not* to engage in a discussion with customers as to the distinction between intraLATA and interLATA services (**<<BEGIN PROPRIETARY**

END PROPRIETARY>>).[115] I have previously noted (at para. 76) how the similarity between the "Pacific Bell" and "Pacific Bell Long Distance" names will create customer confusion and, in some cases, will result in customers **<<BEGIN PROPRIETARY**

END PROPRIETARY>> While it is my overall belief that the existence of such confusion and the potential that customers will be

115. SBC-Pacific response to Working Assets data request 1-1.a, PBCL 011926.

misled by Pacific Bell sales representatives into accepting more costly PBLD services and that for this reason such "joint marketing" should be prohibited, there can be no question but that *if SBC-Pacific is nevertheless allowed to engage in such tactics that derive enormous economic value from PBLD's use of the "Pacific Bell" name*, a royalty for the use of that name should be imposed.

96. The 13% "referral fee" was first adopted in D.87-12-067 as compensation for what were true "referrals" by Pacific Bell employees to affiliates. From the description of the activities before the Commission in that proceeding, it is clear that "referring" is all that the Pacific Bell employees were doing, they were in no sense "selling" or "taking orders for" the affiliates' services. That is clearly not the case here. In fact, PBLD will not even have its own retail-level sales force for transactions with residential and small business customers; it will rely entirely upon *Pacific Bell* employees *not for referrals*, but for *actual sales of PBLD services*. The effort — and the *value* — associated with an actual *sale* is obviously far greater than for a mere "referral," yet in applying the "13% referral fee" to these *sales*, SBC-Pacific is substantially understating the value of the transferred services.

97. The intimate — and clearly not "arm's length" — relationship that is to exist as between the Pacific Bell ILEC entity and the PBLD interLATA affiliate violates the spirit, if not also the letter, of the Section 272(a) separate affiliate requirement as well as the Section 272(b) affiliate relationships. The mere creation of a "separate affiliate" does not by itself assure that such cross-subsidization, self-dealing, diversion of business away from the ILEC,

or other undesirable practices do not arise. The only truly effective solution is outright divestiture — the policy that was adopted with enormous success in the 1984 break-up of the former Bell System. Short of full divestiture, full structural separation, with SBC-Pacific retail entities having precisely the same access to underlying network operations and resources as nonaffiliated CLCs, is the only means for satisfying the requirements of both §709.2(c) and the Commission's affiliate transaction rules.

98. Absent full structural separation, there is no existing mechanism by which the Commission can assure that no cross-subsidization takes place, because any "transfer price" will necessarily be set through regulatory action rather than under market conditions whereby the transferred services are being offered, in the same form and on the same basis, to all other entities, whether affiliates or otherwise. The joint marketing activities that are permitted both by TA96 and by the FCC, in addition to the obvious and insurmountable marketing advantages they confer upon SBC-Pacific, create the potential for massive and "improper cross-subsidization of intrastate interexchange telecommunications service" by SBC-Pacific's monopoly local exchange service operations. Specifically, the joint marketing, "recommendation," and referral activities that have been permitted by TA96 and the FCC are carried out by employees of SBC-Pacific in the course of their dealing with inbound orders from retail customers for *local* telephone service. These valuable sales and referrals made by SBC-Pacific employees on behalf of SBC's long distance affiliate confer enormous value to the long distance affiliate, yet no mechanism exists for compensating SBC-Pacific for the true economic value of the services that it provides to its affiliate.

99. SBC-Pacific Bell is engaging in a cross-subsidization of its affiliate when services furnished by SBC-Pacific Bell to the affiliate are compensated at a transfer price that is anything less than the full market value of such services. In this regard, the use of the phrase "joint marketing" is a misnomer, because it conveys an image of a "joint" activity where SBC-Pacific and its affiliate "cooperate" in jointly marketing their respective services *for the benefit of both entities*. In reality, "joint marketing" as used by SBC with respect to PBLD long distance services constitutes the marketing and selling of PBLD long distance services by the SBC BOC, SBC-Pacific Bell in this case. In such an arrangement, SBC-Pacific Bell is furnishing services to PBLD, and PBLD should compensate SBC-Pacific Bell for the full and fair market value of those services.

100. The specific difficulty in addressing and in preventing this type of cross-subsidization has been addressed in the past by other state commissions. One such case occurred in the late 1980s, and involved the marketing of an affiliate's long distance service by an independent LEC in Ohio. In its decision in that matter, the Public Utilities Commission of Ohio recognized the anticompetitive and cross-subsidization implications of such an arrangement, and directed that the provision and marketing of local and long distance services by carried out by structurally separate affiliates. The Commission concluded:

> After thoroughly reviewing all of the testimony and exhibits in this matter, the Commission finds that the close affiliation between UTLD [United Telephone Long Distance] and its parent company UTO [United Telephone of Ohio] creates a potential for cross-subsidization and anti-competitive practices to occur between the two companies, which would be detrimental to the customers of UTO and, therefore, is not in the public interest. However, the Commission

> believes that, by requiring UTLD and UTO to maintain operations that are structurally separate, the potential for these detrimental practices to occur will be minimized, if not eliminated. Therefore, the Commission concludes that UTLD's application for authority to furnish intrastate interexchange telecommunication services ... should be granted, contingent upon UTLD's and UTO's compliance with the conditions set forth below.
>
> UTLD contends that the use of common operational and managerial resources between UTO and UTLD is beneficial not only to UTLD, but to UTO's customers as well, for a number of reasons one of which is the ability of UTO to spread some of its fixed costs to UTLD. However, the Commission believes that the potential for abuse of this type of structure, especially between two regulated utilities, one of which is an LEC with a monopoly position in its franchised service area, far outweighs any nominal benefits which may or may not ever the realized by either company and their customers. In order to ensure against abuse of UTO's and UTLD's affiliation, it is essential that the two companies operate as totally separate and independent entities. To accomplish this, UTLD and UTO must employ separate directors, officers, and personnel. ... UTO must not share its technical resources and equipment, including, but not limited to, office furniture, data systems, central office equipment and space, and other facilities, with UTLD, unless such resources and equipment are also made available to other IXCs under like conditions.

101. Indeed, while it might be possible to account for the actual work time spent by the SBC-Pacific employees who provide services that directly benefit SBC's long distance affiliate and even to maintain "separate accounting records to allocate costs" of these activities to the affiliate, such actions would in no material sense overcome the inherent cross-subsidization that would be taking place. Under the prevailing "New Regulatory Framework" ("NRF") form of regulation to which SBC-Pacific is currently subject in California, SBC-Pacific is not subject to any cap or limit on its intrastate earnings nor is it required to share any portion of such earnings (e.g., in excess of some threshold level) with its monopoly local

service ratepayers.[116] Hence, any "payment" by Pacific Bell Long Distance to SBC-Pacific for services furnished by the latter to the former amounts to nothing more than a transfer of monies from one SBC pocket to another, and will have no effect whatsoever upon SBC-Pacific's intrastate rates or upon SBC corporate earnings. Thus, the only means by which the Commission can assure itself that SBC-Pacific is not in violation of Section 709.2(c)(3) is through an outright prohibition on any joint marketing, "recommendations," or referrals by SBC-Pacific employees for the benefit of SBC Long Distance or, absent that, a requirement that SBC Long Distance compensate SBC-Pacific for the economic value of those services, which would then be flowed through in some manner to SBC-Pacific's customers or used to pay for the implementation of full structural separation.

As long as SBC-Pacific continues to hold an overwhelming share of the residential local service market and is permitted to engage in *preemptive* selling of its affiliate's Long Distance service, SBC-Pacific will within a relatively few years come to dominate and thus remonopolize the long distance market as well.

102. Section 709.2(c)(4) expressly requires that the Commission "[d]etermine[] that there is no substantial possibility of harm to the competitive intrastate interexchange telecommunications markets." In the discussion that follows, I shall explain why, by virtue of its persistent and overwhelming dominance of the California *local* exchange service market, SBC-Pacific's entry into the interLATA long distance market will undermine competition in

116. The original NRF structure, adopted in D.89-10-031, 33 CPUC2d 43, contained both of these features. However, in D.98-10-026 (mimeo, at 49), the Commission eliminated both the sharing and earnings cap requirements.

what is today a highly competitive intrastate interexchange telecommunications market and could well lead to eventual remonopolization of that market by SBC-Pacific.

103. SBC-Pacific asserts that granting it Section 271 authority in California will enhance competition in the long distance market. Specifically the Company claims that its entry into the long distance market will prompt the three largest incumbent long distance carriers — AT&T, WorldCom and Sprint — to provide long distance customers with more innovative calling plans and cheaper prices.[117] Incredibly in light of its recent price hikes in Texas, SBC-Pacific is nevertheless arguing here in California that the existing long distance rates in its service territory are currently inflated above the actual costs of providing the services[118] and that SBC-Pacific's entry into the long distance market will remedy the problem while benefiting consumers with lower rates. It is difficult to understand how this claim can be reconciled with SBC's recent pricing moves in Texas. **<<BEGIN PROPRIETARY**

END PROPRIETARY>>[119]

Assuming that this view is founded upon bona fide marketing intelligence and experience in

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117. SBC-Pacific June 27, 2001 Section 271 Application, at iv.

118. *Id.*

119. SBC-Pacific response to Working Assets data request 1-1.a, PBCL 011918.

Texas, Oklahoma and Kansas rather than just narcissism on SBC-Pacific's part, it is clear that the affiliation, integration and use of the Pacific Bell name are expected to be enormously valuable and financially rewarding to PBLD.

104. SBC-Pacific's contention that long distance rates would decrease following SBC-Pacific's entry necessarily presupposes (a) that the long distance market as it presently exists is *not* fully competitive, such that prices are being set at supracompetitive levels, and (b) that SBC-Pacific's entry would not result in *increased market concentration* overall. As to the first premise, SBC-Pacific offers no credible evidence to support the notion that the existing long distance market is less than fully and robustly competitive; indeed, when compared with the state of the *local* market, of which SBC-Pacific controls upwards of 90% and where prices have not materially decreased in decades, no long distance carrier currently holds even a 50% share, and long distance prices have been plummeting since the onset of equal access in the late 1980s. The most compelling evidence in support of the presence of robust competition in the long distance market can be seen in the fact that interexchange carriers have been regularly flowing decreases in access charges through to their retail customers, and in many cases have decreased their retail rates *in excess* of the reduction in access charges.

105. The second premise of SBC-Pacific's claim is that its entry will result in less concentration in the long distance market. As I shall demonstrate below, as long as SBC-Pacific continues to maintain its present position of dominance in the *local* service market, it will soon come to dominate the long distance market as well.

106. To the extent that the BOC maintains a *de facto* monopoly with respect to the provision of *local* services in part or in all of any state in which it has received Section 271(c) authorization, the effect of this preemptive joint marketing opportunity is to permit the BOC to extend its local monopoly into the adjacent, and otherwise competitive, long distance market.

107. Presumably, the principle/theory (if there is one) driving the FCC's and Congress' acquiescence in such "joint marketing" is that if the *local* market *is* competitive and as such if customers are given real choices as to whom they contact for local service (which is the presumption once the "Competitive Checklist" has been satisfied), the RBOC then no longer enjoys any advantage vis-a-vis CLCs with respect to selling customers long distance service either, because CLCs are also free to sell long distance service to *their* local service customers. The principle/theory breaks down, of course, if the local market is not actually competitive, i.e., if customers have no choice but to contact the BOC for local service and if the BOC retains the right to preemptively market long distance service to those customers, then other long distance providers will be blocked from addressing these customers.

108. Put another way, the larger the BOC's share of the *local* market, the greater will be its opportunity to preemptively market its affiliate's long distance service. And if customers exhibit a disproportionate propensity to select the BOC as their long distance carrier as a result of this "first to get there" opportunity, then over time the BOC's long distance market

share would also be expected to grow *directly and specifically as a consequence of its ability to preempt competing long distance carriers in signing up new customers.*

109. The proposition advanced in the preceding paragraph may be tested quantitatively by means of a dynamic model of market behavior over time. Attachment 6 to this Declaration contains the results of a model I have constructed for this purpose, along with several alternative model runs designed to examine the sensitivity of the model's results to variations in the BOC's share of the *local* market. The model was developed based upon actual experience in New York and Texas following the entry of Bell Atlantic (now Verizon) and SBC, respectively, into the in-region long distance markets in those states, modified where appropriate to reflect conditions specific to California.

110. According to the US Census Bureau, each year on average some 17% of all US households relocate to a new residence.[120] Thus, each year approximately 17% of SBC-Pacific's residential customers can be expected to initiate an order for new local telephone service. In the model, I have assumed that Pacific's share of these inward service orders will correspond with its share of the local exchange service market overall. Relying upon SBC-Pacific estimate of its own residential lines and competitor residential lines in SBC-Pacific's

120. U.S. Census Bureau, American Housing Survey for the United States in 1999, Table 2.9.

territory, SBC-Pacific's share of the residential local service market is currently 95.3%.[121] Thus, in any given year (and assuming that the churn rate and market share remain constant), SBC-Pacific will have the opportunity to "address" 16.2% (i.e., 17% household relocation rate x 95.3% residential market share) of all residential customers in SBC-Pacific's service area as a result of *customer-initiated* "inbound" contacts.

111. The model assumes that in approximately 82.4% of such customer-initiated contacts in which an order for new local service is placed, the customer selects Pacific Long Distance as the PIC following the "recommendation" of the Pacific service representative.[122] 28.9% of California households have at least two residential access lines,[123] and (assuming that the same relocation rate applies to these households as to the population generally) it is likely that

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121. SBC-Pacific witness Tebeau reports 10,979,183 SBC-Pacific residential access lines and 537,482 competitor access lines in California (375,991 E911/UNE-P plus 161,491 resale). See Tebeau (SBC-Pacific), at Table 1; Table 5; and Attachment A, Item 14.

122. This 82.4% Verizon Long Distance "take rate" for "inbound" local service customers was developed as follows: Verizon Long Distance claims to have captured a 20% share of the New York market in the first year in which its entry was allowed. "Verizon Communications Posts Strong Results for Fourth Quarter and 2000," Verizon News Release, February 1, 2001. On average, about 30% of residence customers change their PIC in any given year. "J.D. Powers and Associates Reports: Sprint and SNET Top Performers in Residential Long Distance Customer Satisfaction," July 29, 1999. Thus, 6% (20% of 30%) out of Verizon's 20% total long distance market share is attributable to PIC changes made by existing customers. The remaining 14% would then be attributable to inbound local service customers selecting Verizon Long Distance at the time that they placed their orders for local service. Since the overall residential relocation rate is 17%, I have estimated the "take rate" at 14%/17%, or 82.4%.

123. FCC *Trends in Telephone Service*, August 2001, Table 8.4.

a customer with an additional line will select the same long distance carrier for both the primary line and the additional line.[124]

112. Offsetting these "captures" of customers by SBC-Pacific Long Distance are the ongoing marketing efforts of the other IXCs. In 1999, approximately 30% of all US residential customers changed their PIC.[125] Extrapolating this to California, the model assumes that each year 30% of the customers who had SBC-Pacific long distance service at the beginning of the year will switch to another IXC (which I assume to occur at mid-year, on average) sometime during the year. However, Pacific will also be marketing its long distance service to customers of other IXCs, and so the model also assumes that Pacific will capture a portion of those customers' PIC changes as well. Specifically, the model uses Pacific's long distance market share at the beginning of each year to determine what proportion of all non-Pacific PIC changes will be captured by Pacific during that year (with the exception of year 1, in which the 20% end-of-year share captured by Verizon in New York is used).

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124. In fact, as discussed above, the FCC has ruled that where the contact is initiated by an *existing* BOC customer (e.g., to order an additional line or to add vertical service features), the BOC *will not be required* to offer to read the list of available IXCs. *AT&T/BA-NY Order*, at para. 15. As a result, it is likely that the customer's propensity to selected the BOC's Long Distance affiliate as the PIC would be even higher for additional lines than for the primary line, where the BOC is required to offer to read the list of IXCs. Since the model assumes the *same* "take rate" for both primary and additional lines, it likely errs on the conservative side.

125. J.D. Powers report, *op. cit.*, footnote 117.

113. Scenario 1 in Attachment 6 provides the results of this model, and demonstrates that if the SBC-Pacific *local service* market share of 95.3% is maintained throughout the five-year period covered by the model, at the end of that time SBC Long Distance will have captured some 69.9% of all California residential subscribers in SBC-Pacific's service territory.

114. In Scenario 2 in Attachment 6, I have changed the original assumption regarding SBC-Pacific's share of the local market. Rather than holding it constant at the current 95.3% level, I have assumed that it will fall by 3% annually through the fifth year. All else remaining the same as per the original (page 1) model, this erosion in SBC-Pacific's local market share (down to 80.3% at the end of the fifth year) will still provide Pacific with a 64.8% share of the residential long distance market as of the end of the study period.

115. In Scenario 3 in Attachment 6, I have modeled the case where CLCs are even more successful (than in the page 3 model) in capturing *local* customers. Here, I have assumed that CLCs capture 10% of residential customers in the initial year following Section 271 approval, and have assumed additional annual CLC market share growth at half of the initial year rate for each of the next four years. At the end of the fifth year, SBC-Pacific's local market share would then be 65.3%, but its long distance market share will still be larger than that for any IXC today, at 58.3%.

116. While the model attempts to address certain market dynamics, it does not consider all of them. For one, it assumes that all of the existing non-BOC IXCs remain in business during the entire period, i.e., that despite the persistent expansion of the BOC's share of the long distance market, the other carriers continue to remain profitable and continue to maintain the same type of market *and marketing* presence that they do today. The recent and precipitous decline in the value of IXC stocks would, however, suggest that Wall Street expects otherwise. Massive IXC market share losses over a short period of time are likely to result in one or more of the major IXCs exiting the market, an outcome that would be almost certain to further increase Pacific's ultimate market share.

117. There are strong parallels between the various policy initiatives taken during the 1980s that were designed to open the long distance market to entry by "Other Common Carriers" ("OCCs," defined as interexchange carriers other than AT&T) and the current policy moves toward authorizing BOC entry into the long distance market. In the earlier case, OCC entry and growth were facilitated by (a) the requirement that BOCs (and later extended to ILECs generally) provide "equal access" and associated dialing parity to all IXCs, (b) the requirement that *discounted* access charges apply to OCCs prior to the introduction of equal access in any central office, (c) "balloting" of BOC customers with respect to the choice of PIC and *assignment* of nonresponding BOC customers to OCCs in proportion to the selections made by responding customers, (d) adoption of an "equal charge per minute of use" rule, which deprived AT&T of any opportunity to benefit with respect to access charges paid to ILECs from its size, incumbency or scale economies relative to those of its smaller rivals, and

(e) adoption of the so-called "five-mile rule," under which all OCCs locating their points of presence ("POPs") within five miles of an ILEC access tandem would be subject to the same access charges as would AT&T (which was often collocated with the BOC), thereby eliminating any incumbency and preexisting collocation advantages that might otherwise have benefitted AT&T. AT&T was also subject to a disproportionately-applied "equal access recovery charge," forcing it to pay a relatively larger share of the costs of implementing equal access than its OCC rivals. The current analogy to "equal access" is the Section 271(c)(2) 14-point "Competitive Checklist." The remaining policy initiatives were expressly intended to jump-start long distance competition, to give the OCCs certain specific opportunities to expand their market that would overcome the enormous obstacles confronting any non-incumbent attempting to enter a market long dominated by a single firm.

118. The transition to equal access began in 1985 and was substantially complete by the end of 1988. The 1985 beginning of the transition to equal access is analogous to the initial satisfaction of the 14-point checklist (which is not required to have been satisfied in every BOC exchange statewide as a prerequisite for Section 271 authorization). By the end of the fifth year (i.e., by the end of 1990), the non-AT&T IXCs had acquired 24.4% of presubscribed lines nationwide. As I have discussed, the model I have constructed predicts BOC shares (also in terms of presubscribed lines) in the range of 69.9% to 58.3% at the end of the fifth year following BOC long distance entry).

119. In view of the strong parallels between OCC entry in the 1980s and BOC entry today, I believe that the *results* of the earlier policy paradigm offer a useful and reasonable standard against which the current policy initiatives relative to BOC entry can be evaluated. In order to facilitate this examination, I have used the model to estimate the share of the *local* market that CLCs would have to acquire over the five-year period in order to limit the BOC *long distance* market share to the same 24.4% of presubscribed lines that the OCCs were able to acquire as of five years following the initiation of equal access. As Scenario 4 in Attachment 6 indicates, the CLC market share that would be required to achieve this outcome is 79.25% as of the beginning of year 2 and through to the end of year 5. In view of the fact that by SBC-Pacific's own account CLCs currently have only a 4.7% local service market share, it is virtually *inconceivable* that CLCs could achieve a local service penetration rate of 79.25% or anything remotely close to it over the coming five-year period.

120. From the foregoing discussion and analysis, it is evident that the development of effective competition for *local* services is critical to forestall remonopolization of the long distance market following BOC entry. As long as BOCs are permitted to exploit their captive relationship with the vast majority of local service customers to market and sell their long distance services, BOC long distance shares will grow rapidly and non-BOC IXCs will suffer a precipitous decline in customers and demand. Faced with such losses, IXC costs will rise and at least some IXCs will be forced to exit the business, further exacerbating the situation and affording the BOCs an even greater opportunity to remonopolize the nation's long distance market.

Separation of SBC-Pacific's retail functions from its underlying network operations is necessary to bring about the local service competition that had been envisioned under the Commission's local competition decisions and TA96, because SBC-Pacific will not be able to demonstrate compliance with the local exchange market-opening obligations specified in §709.2(c)(1) and the Section 271 fourteen-point "Competitive Checklist" unless structural separation has been implemented.

121. §709.2(c)(1) requires the Commission to "[d]etermine[] that all competitors have fair, nondiscriminatory, and mutually open access to exchanges currently subject to the modified final judgment and interexchange facilities, including fair unbundling of exchange facilities, as prescribed in the commission's Open Access and Network Architecture Development Proceeding (I. 93-04-003 and R. 93-04-003)" as a threshold condition for the grant of a certificate allowing SBC-Pacific into the intrastate interLATA long distance business. The California legislature's concern in enacting this section was well-taken. As both a wholesale provider of essential facilities to interexchange carriers (access services) and CLCs (bundled wholesale services, Unbundled Network Elements, and various interconnection arrangements for the interchange of traffic) as well as a *retail* provider of these services competing directly with the very same interexchange and competitive local exchange carriers, SBC-Pacific has both strong financial incentives and extensive opportunities to engage in a pattern of conduct that is directly inconsistent with the explicit requirements of Section 709.2(c)(1). Such conduct, which is extremely difficult to detect except through after-the-fact complaints initiated by its victims, works to undermine the potential for local service competition at its most fundamental level and has the potential to undermine the robust competition that presently exists in the interLATA long distance market. Responding to such complaints, ILECs typically assert that the actions or conduct to which the objection has been

lodged either did not occur at all or was the result of an isolated incident that has been/is being/will be corrected. SBC's failure to provide adequate treatment of CLCs has subjected SBC to various fines and penalties in California and elsewhere, although the dollar magnitude of such fines, which are also subject to a cap, has clearly been insufficient to deter SBC from persisting in the same pattern of behavior.[126]

122. In many cases, ILEC conduct may be perfectly "legal" while still working to frustrate competition and entry: For example, SBC offers CLCs a "template" Interconnection Agreement consisting of hundreds of pages in multiple separate files that the CLC must download from the SBC website.[127] The CLC then marks-up the "template" contract and submits it to SBC for a response. This process may consume several months and, if no agreement is reached, may require the CLC to pursue lengthy and costly arbitration before each state PUC in which it seeks to obtain interconnection. SBC can also exercise its legal right to appeal adverse PUC rulings, further delaying an entrant's ability to commence operations or forcing it to accept the template agreement as essentially an "adhesion contract."

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126. Legislation recently introduced by Sen. Ernest F. Hollings (D., S.C.), the *Telecommunications Competition Enforcement Act*, would substantially increase these fines because, according to Sen. Hollings, "the fines at the FCC are too small to have any real effect." In introducing the bill, Sen. Hollings is quoted as stating that "Given the lack of competition in the local markets, the intransigent behavior of the Bell companies, and concerns about poor service quality, we are left with no choice but to adopt measures that will ensure Bell compliance" with the telecom act. *TR Daily*, August 3, 2001.

127. http://clec.sbc.com

123. The extent to which SBC-Pacific may be engaging in one or more forms of anticompetitive conduct can only be accurately assessed in terms of actual marketplace *results* rather than by an examination of individual incidents. Intense competition has developed in virtually every segment of the US telecommunications industry in which the RBOCs do not maintain some form of bottleneck control over essential facilities, either because such control has been expressly prohibited by legislative, judicial or regulatory fiat (as in the case of the structural separation of the local and long distance businesses that was created by the break-up of the former Bell System[128] permitting the development of competing long distance carriers; the requirement imposed upon ILECs by the FCC that customer premises equipment (CPE) be permitted unrestricted interconnection to ILEC networks,[129] which catalyzed the development of an intensely competitive and innovative CPE market; and the separate subsidiary, interconnection, reciprocal compensation, and resale requirements imposed upon CMRS providers together with the licensing of multiple carriers in each market area) or in which the RBOCs have themselves had minimal involvement (e.g., and at least up to now, dial-up access to the Internet). On the other hand, where RBOCs have been permitted to engage in retail operations in markets in which they also control essential facilities (e.g., local exchange service), competition has failed to develop. It is ludicrous to suggest that non-RBOC capital, which has pumped upwards of $100-billion into the US telecommunications

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128. See *supra*, footnote 5.

129. *Proposals for New or Revised Classes of Interstate and Foreign Message Toll Telephone Service (MTS) and Wide Area Telephone Service (WATS)*, CC Docket 19528, *First Report and Order* 56 FCC2d 593, 613 (1975); *Reconsideration* 57 FCC2d 1216 (1976); *Further Reconsideration* 58 FCC2d 716 (1976); *Second Report and Order* 58 FCC2d 736 (1976).

market since enactment of TA96, has simply chosen to ignore the local exchange service market, leaving it to the continued control of the incumbents. A far more realistic explanation for the utter lack of competition for local services is the affirmative and concerted efforts by incumbent LECs generally and by SBC in particular to prevent rivals from gaining more than minimal niche footholds in what remains for most practical purposes a *de facto*, if not technically a *de jure*, local service monopoly. Thus, the kind of anecdotal evidence of "competition" being advanced by Mr. Tebeau cannot and must not be permitted to mask the undeniable *fact* that all identifiable "local competition" combined does little or nothing to constrain SBC-Pacific's unrivaled market power in the California local telecommunications market.

124. Structural separation of those portions of SBC-Pacific's operations that provide essential network resources to competing retail services from those portions of SBC-Pacific's operations that are themselves involved in the retail provision of service to end user customers is essential to prevent such anticompetitive conduct. Under structural separation, SBC-Pacific-retail would be required to deal with SBC-Pacific-wholesale in exactly the same manner and under the same terms, conditions, and operational interfaces as its nonaffiliated retail competitors. Structural separation is thus *essential* for effective competition because SBC-Pacific cannot be expected to take the steps necessary to open its market to competition *in the absence of structural separation of its wholesale and retail operations.*

125. The purpose of the Section 271(c)(2)(B) "Competitive Checklist" is to ensure that competition for local exchange services is sufficiently developed within the BOC's service territory that the BOC will be unable to leverage excessive market power in the provision of local exchange services in a manner that would allow it to dominate the adjacent interLATA services market, to the detriment of consumers and competing long distance service providers.[130] The various requirements set out in the "Competitive Checklist" are based upon, and in many cases refer directly to, the requirements for network interconnection and unbundling that are set forth at Section 251 ("Interconnection") of the Act, as well as the various BOC/CLC interconnection agreements negotiated pursuant to the procedures established by Section 252 ("Procedures for Negotiation, Arbitration, and Approval of Agreements"). Section 271 thus offers certain incumbent LECs, specifically Bell Operating Companies, the "carrot" of long distance entry as a reward for compliance with Sections 251 and 252, *which all incumbent LECs are obligated to do in any event.*

126. Condition 1 of the Competitive Checklist requires the BOC to provide interconnection "in accordance with the requirements of sections 251(c)(2) and 252(d)(1),"[131] meaning that the BOC must provide a requesting CLC interconnection with its local exchange network on a nondiscriminatory basis at any technically feasible point, at a

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130. Section 271(c)(1)(B), "Failure to Request Access," also allows for the possibility that local exchange competition might not develop in a particular market for reasons outside of the control of the BOC applying for interLATA authority, in which case such authority might still be granted.

131. Section 271(c)(2)(B)(i).

quality at least equal to that which the BOC provides to itself, and at cost-based rates. Condition 2 of the Competitive Checklist applies the same nondiscrimination requirement to the BOC's provision of access to its network elements on an unbundled basis. Conditions 3-10 of the Competitive Checklist establish similar nondiscrimination requirements for particular facilities and functionalities afforded by the BOCs to CLCs. Finally, Conditions 11-14 treat additional areas of BOC-CLC interaction that are crucial for competitive entry into local exchange markets, including the establishment of telephone number portability, dialing parity, and reciprocal compensation arrangements for interchanged traffic, as well as the resale of BOC services.

"Separate but equal" access to the ILEC's network does not a "level playing field" make.

127. Sections 251/252 and 271 have been interpreted by the FCC as requiring that incumbent LECs provide CLCs with access to their networks in ways that are "nondiscriminatory" and "at least equal in quality" to access arrangements that the ILEC provides to itself for its own use in furnishing its own retail services to end users: At para. 26 of its *First Report and Order* in CC Docket No. 96-98, the Commission succinctly summarized this overarching policy paradigm:

> 26. Section 251(c)(2) requires incumbent LECs to provide interconnection to any requesting telecommunications carrier at any technically feasible point. The interconnection must be at least equal in quality to that provided by the incumbent LEC to itself or its affiliates, and must be provided on rates, terms, and conditions that are just, reasonable, and nondiscriminatory. ...

128. CLCs are not even receiving the "separate but equal" treatment that is called for in the *Act* and in the FCC's rules. As a result, SBC has been required to pay, and has paid, more than $38-million in fines and penalties to the United States treasury as well as to CLC victims of its less-than-equal treatment.[132] This subject is addressed in greater detail in the Declaration of Ethan Sprague on behalf of Pac-West Telecom.

129. It has become painfully clear that, in practice, this "separate but equal" paradigm has failed to achieve Congress' and the FCC's goals. Rather, it has served to invite seemingly limitless argument and protracted litigation over exactly what terms like "at least equal in quality" and "nondiscriminatory" mean. ILECs do not permit CLCs to interface with their network operations support systems and other network resources in the same manner as is afforded the ILEC's own retailing and service provisioning organizations. CLCs are required, as it were, to enter the ILEC "through the front door" while the ILEC's own operating units are permitted "side-door" and "back-door" access.

130. SBC-Pacific, for example, has established special bureaus that deal solely with CLC orders for unbundled network elements and other interconnection arrangements. SBC-Pacific operates these bureaus, known as the "Local Interconnection Service Center" ("LISC"), as specialized retail service organizations whose "customers" happen also to be the ILEC's competitors. SBC-Pacific has interpreted the "at least equal in quality" requirement to one that treats competitors the same as SBC-Pacific treats its own *retail* end user customers,

132. *TR Daily*, July 27, 2001.

rather than as one that requires it to treat competitors the same as it treats its own *organizational units* that handle retail service orders. Consider the following analogy: Suppose that a particular clothing manufacturer sells its products both through its own retail outlets as well as through nonaffiliated retail distribution channels. For such an arrangement to operate, the nonaffiliated retailers must be permitted to order merchandise directly from the factory and pick it up at the factory's loading dock, just as the affiliated retail stores would do. What SBC-Pacific's policy amounts to, however, is one that would require the nonaffiliated retail stores to purchase their merchandise *at retail* (perhaps less some "volume discount") from the manufacturer's own retail outlets, and not be permitted to deal directly with the factory either for the placement of orders or for the pick-up of merchandise. In a competitive market, the competing (nonaffiliated) retailers would never put up with such an arrangement, whose effect would be both to delay their receipt of merchandise (because of the intervention of the manufacturer's own retailing organization) as well as to increase their costs. In a competitive environment, producers cultivate and nurture their distribution channels because that is how they bring their products to market. Only where competition does not exist, as in the case of basic local exchange service, would a service provider (SBC-Pacific in this instance) attempt to *restrict*, rather than to *cultivate*, its distribution channels.

131. Importantly, these practices on the part of SBC are limited to those areas in which SBC maintains a *de facto* monopoly. Where SBC is itself forced to compete aggressively with other service providers and where it lacks the advantages of a captive customer base, SBC uses far more traditional, competitive retail distribution practices. Consider, for

example, the case of SBC's wireless affiliate, Cingular, where SBC affirmatively seeks out *nonaffiliated* retail channels like consumer electronics and discount stores. Cingular also maintains a relatively small network of its own retail stores. I seriously doubt that the nonaffiliated retail distributors of Cingular service are being required to place orders for wireless services through the Cingular retail outlets; rather, I expect that both the affiliate Cingular retail stores and the nonaffiliated Cingular retail distribution channels are being afforded essentially identical and truly equal access to the Cingular service ordering and provisioning systems.

132. There is a wide range of potential discriminatory behavior that BOCs can undertake in order to frustrate competitive entry by CLCs. In its seminal *Local Competition Order* implementing some of the major provisions of TA96, the FCC acknowledged as much, and identified some specific forms of discrimination:

> We are cognizant of the fact that incumbent LECs have the incentive and ability to engage in many forms of discrimination. For example, the incumbent LECs could potentially delay providing access to unbundled network elements, or they could provide them to new entrants at a degraded level of quality.[133]

A more complete (but by no means exhaustive) list of potential discriminatory behavior includes the following:

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133. *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, CC Docket Nos. 96-98 and 95-185, *First Report and Order*, released August 8, 1996, ("*Local Competition Order*"), at para. 307.

- Refusing to interconnect at a point that is admitted to be technically feasible;

- Unreasonably resisting the classification of a particular requested interconnection point as technically feasible;

- Similarly, refusing to provide a technically-feasible unbundled network element, or unreasonably treating such an element as not technically feasible;

- Unreasonably delaying the implementation of procedures necessary to make such an interconnection or unbundled network element available;

- Limiting the availability of requested points of interconnection, unbundled network elements, or other network functions referenced in the Competitive Checklist by imposing unreasonably restrictive terms and conditions, including unreasonably long ordering/provisioning intervals;

- Providing any of the items covered by the Competitive Checklist at a service quality level that is inferior to that provided to the BOC's own retail operations;

- Imposing excessive, non-cost-based prices for interconnection or unbundled network elements contrary to Section 252(d)(1) of TA96; and

- Failing to provide reasonably timely and accurate information concerning the status of CLC orders of unbundled network elements or other wholesale services, particularly with respect to the dimensions of service ordering that impact end user customers (e.g., service due dates, cutover coordination, etc.).

133. The FCC has repeatedly recognized that the potential for ILEC discrimination against new entrants to their retail local exchange markets is essentially an intractable, structural problem. In the context of its evaluations of the merger applications of both SBC/Ameritech and Bell Atlantic/GTE, the FCC concluded that ILECs have the ability and the incentive to discriminate against CLCs that rely upon the ILECs' inputs (including interconnection and unbundled network elements) to compete.[134] In its 1999 order granting conditional approval of the SBC/Ameritech merger, the FCC essentially elevated this realization to the level of a cornerstone of modern US telecommunications policy:

> Incumbent LECs in general have both the incentive and ability to discriminate against competitors in incumbent LECs' retail markets. This observation is the fundamental postulate underlying modern U.S. telecommunications law. The divestiture of AT&T rested principally on this observation. Two key sections of the 1996 Act, sections 251 and 271, rest entirely on this point. Incumbent LECs have an incentive to discriminate against rivals to gain the business that these rivals lose as a result of such discrimination. This incentive exists in all retail markets in which they participate. Incumbent LECs' ability to discriminate against retail rivals stems from their monopoly control over key inputs that rivals need in order to offer retail services.[135]

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134. See *infra*, para. 38.

135. *SBC/Ameritech Merger Order*, 14 FCC Rcd at 14712, 14797 (para. 190).